



1 of 79 DOCUMENTS

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Jaworski on the Mortgage Reform and Anti-Predatory Lending Act

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Robert M. Jaworski on Back to the Future with the Mortgage Reform and Anti-Predatory Lending Act (Part of Dodd-Frank)

By Robert M. Jaworski Esq.

October 6, 2010

SUMMARY: Robert M. Jaworski analyzes the Mortgage Reform and Anti-Predatory Lending Act (in Dodd-Frank Act), including the significant changes that it makes to the Truth in Lending Act (e.g., incentives for qualified mortgages, anti-steering prohibitions, defenses to foreclosure, disclosure & servicing requirements, & appraisal-related rules) and RESPA (e.g., changes to rules re: qualified written requests); and what this reform suggests about the future.

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ARTICLE: Not too long ago, residential mortgage loans were available only to consumers who were able to put at least 20% down toward the purchase of a home, had good credit, and earned income in an amount the lender determined was sufficient in relation to his/her outstanding debt and which the lender would typically verify by checking with the consumer's employer. Now, in reaction to the catastrophic events in the financial markets of the last several years, Congress, through its enactment of the **Mortgage Reform and Anti-Predatory Lending Act ("MRAPLA")**, also known as **Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")** n1, appears to be taking us back to the future.

Background: How We Got Here

The MRAPLA includes a statement of the "Sense of Congress" that "[t]he hybrid public-private status of Fannie Mae and Freddie Mac is untenable" and that "meaningful structural reforms of Fannie Mae and Freddie Mac" are needed and supports this statement with various statistics. n2 These statistics may also help to explain how we got into this mess in the first place.

In 1995-96, in an attempt to expand homeownership, the U.S. Department of Housing and Urban Development ("HUD") imposed a requirement upon Fannie Mae and Freddie Mac (collectively, the "GSEs") that at least 42% of their mortgage financing should go to borrowers with income levels below the median for a given area. To help the GSEs fulfill this mandate, HUD also authorized them for the first time to purchase subprime mortgage loans made to low income borrowers.

In 2004, HUD increased the required percentage of purchases by the GSEs of below-median loans from 42% to 56% of their portfolios. At this same time, HUD imposed an additional mandate that at least 12% of all mortgage purchases by the GSEs be "special affordable" loans to borrowers with income less than 60% of the area median income. Four years later, HUD more than doubled this mandate from 12% to 28%.

These mandates alone, however, only help to explain how we started down this road. There were other important factors as well, including the Wall Street securitization engine and its demands for more and more loans; the proliferation and use of automated underwriting systems, which reduced paperwork and speeded the origination process; an over-reliance by lenders on credit scores; and, above all, an irrational confidence that real estate values would continue to go up. And there was also the fact, in some part due to these trends, that many bankers and non-bank mortgage originators loosened their credit standards during this period, developed non-traditional and ever most exotic mortgage products (stated income loans, hybrid ARMs, interest-only balloon loans, option-pay ARMs) and lowered their loan-to-value (LTV) requirements.

The immediate result was that the GSEs bought more subprime and Alt-A loans and more loans with low down payments. From 2001 to 2006, subprime and near-prime loans as a percentage of all residential mortgages increased from 9% to 40%. From 2003 to 2007, the market share of conventional mortgages dropped from 78.8% to 50.1% and the market share of subprime and Alt-A loans increased from 10.1% to 32.7%. And, from 2005 through 2007, Fannie and Freddie purchased approximately \$1 trillion in subprime and Alt-A mortgage loans, and Fannie's purchases of loans with less than 10% down payments almost tripled.

The end result was that, on September 7, 2008, Fannie and Freddie were placed into conservatorship, exposing U.S. taxpayers to upwards of \$5.3 trillion worth of risk.

Plain Vanilla Loans: The Once and Future King

The MRAPLA represents Congress's reaction to these developments.. In a very real sense, that reaction is to try to encourage lenders to make more plain vanilla loans and, in doing so, to reimpose to some extent the old-fashioned mortgage lending standards referred to above - high down payments, good credit, verified income.

The MRAPLA creates, as part of the Truth in Lending Act ("TILA"),ⁿ³ the concept of a "qualified mortgage," and indicates that a qualified mortgage will be free of many of the restrictions and limitations imposed by the MRAPLA on other mortgage loans. Congress evidently felt that it was a good idea to encourage lenders to make conservatively underwritten "plain vanilla" loans to consumers at a reasonable cost by exempting such loans from many of these new restrictions and limitations.

Qualified Mortgages. What exactly is a "qualified mortgage"? The MRAPLA defines it as a mortgage loan (i) that does not allow for negative amortization and is not a balloon loan, (ii) for which the creditor verifies and documents the borrower's income and assets, (iii) that is underwritten using a fully-amortizing payment schedule (for an ARM loan, underwritten based on the maximum rate permitted during the first 5 years of the loan term) taking into account all applicable taxes, insurance and assessments, (iv) for which total points and fees do not exceed 3% of the total loan amount, and (v) that complies with debt-to-income ratios established by the Federal Reserve Board (FRB).ⁿ⁴

Specific Incentives Attached to Qualified Mortgages. As indicated, the MRAPLA "encourages" lenders to make (and investors to purchase) qualified mortgages by exempting such loans from several of the restrictions and limitations that the MRAPLA places on mortgage loans generally.

One of the most significant of these restrictions is a requirement which the MRAPLA inserts into TILA that creditors make a reasonable and good faith determination, based on verified and documented information that, at the time the loan is consummated, the borrower has a "reasonable ability to repay" it according to its terms, along with all applicable taxes, insurance (including mortgage guarantee insurance) and assessments.ⁿ⁵ This extraordinary statutory expansion of a lender's responsibility to assure creditworthiness is fraught with risk for the lender, especially when a

loan defaults.

The MRAPLA also amends TILA to specify, among other things, the specific credit factors that the creditor must consider in determining a borrower's ability to repay, including what documents the creditor must review to verify income and assets, and how the creditor must go about assessing ability to repay a non-standard loan (essentially, an ARM loan that allows for the deferral of any principal or interest, an interest-only loan, or a loan that allows for negative amortization). Creditors making "qualified mortgages" under certain conditions, however, will be presumed to have fulfilled these requirements. n6

In addition, the MRAPLA changes TILA to forbid prepayment fees for most residential mortgage loans, except that fixed-rate "qualified mortgages" with APRs that do not exceed a specified level may include prepayment penalty provisions under certain conditions. n7 Also, creditors may make "qualified mortgages" to first-time homebuyers without first requiring those homebuyers to obtain HUD-approved homeownership counseling. n8 And "qualified mortgages" are not subject to the special appraisal rules that the MRAPLA makes applicable to "higher risk mortgages." n9

Last but certainly not least, Title IX of Dodd-Frank includes a provision requiring securitizers of mortgage loans to retain a small component of the credit risk associated with those loans. However, securitizers of loan pools comprised exclusively of "qualified residential mortgages" (to be defined by the FRB by regulation in accordance with specified standards similar to those that define a "qualified mortgage") are exempted from the requirement in Dodd-Frank that they retain a material portion of the credit risk associated with these loans when they transfer, sell or convey them to a third party. n10 Since some or all of this credit risk may be shifted by the securitizer to the originator, the exemption provides further encouragement to originators to make qualified mortgages.

Other MRAPLA Restrictions and Limitations

The MRAPLA also amends TILA to impose numerous other important restrictions and limitations in connection with the origination and servicing of residential mortgage loans (including qualified mortgages) that also seem intended to take us back to an earlier time. Some of these are outlined below.

Anti-Steering Prohibitions. The most significant restrictions concern "steering" n11 and perhaps the most significant of these is a prohibition against the payment to or receipt by a mortgage originator of any direct or indirect compensation "that varies based on the terms of the loan (other than the amount of the principal)." This means that, once this provision becomes effective, mortgage brokers and even loan officers who work for mortgage lenders or brokers may no longer earn premiums for originating loans at above par rates or with prepayment penalties or other specific loan terms that may make the loan more valuable on the secondary market. For example, "yield spread premiums" would not be permitted, although that issue may be moot due to Regulation Z changes that will take effect earlier than the MRAPLA. This section, however, does not limit the compensation that a creditor may receive on the sale of a loan or incentive payments to mortgage originators that are based on the *number* of loans originated within a specified period.

The MRAPLA also prohibits the receipt by a mortgage originator of an origination fee or charge from someone other than the consumer, and the payment of an origination fee or charge by such a person (other than bona fide third party charges not retained by the creditor, the mortgage originator or an affiliate of either) to a mortgage originator if the person knows or has reason to know of the consumer's payment of direct compensation to the originator. An exception is provided if the mortgage originator is not receiving any compensation directly from the consumer and the consumer is not making any upfront payment of discount points, origination points, or fees (again, other than bona fide third party charges not retained by the creditor, the mortgage originator or an affiliate of either). Additionally, the steering of a consumer by a mortgage originator to a loan that (i) the consumer "lacks a reasonable ability to repay," (ii) has predatory characteristics, or (iii) is not a "qualified mortgage" when the consumer qualifies for a "qualified mortgage," is also prohibited, as are "abusive or unfair lending practices that promote disparities among consumers of equal credit

worthiness but of different race, ethnicity, gender, or age."

Other Restrictions. The MRAPLA also provides the FRB with expansive authority to adopt regulations relating to mortgage loans that it finds to be "abusive, unfair, deceptive, [or] predatory," or that it deems to be "necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers." n12

In addition, the MRAPLA prohibits creditors of residential mortgage loans and home equity lines of credit ("HELOCs") from: (1) financing single premium credit insurance; (2) including mandatory arbitration clauses in the loan documents; (3) having payment schedules that allow for negative amortization; (4) making refinance loans that would cause the borrower to lose state anti-deficiency protections without disclosing that effect in advance of closing; and (5) as previously indicated, making non-qualified mortgages to first-time homebuyers who have not received HUD-approved homeownership counseling. n13

New Disclosures. The MRAPLA also amends TILA to require that: (1) 6 months prior written notice be given to borrowers facing resets of hybrid ARMs (consumer credit transactions secured by the consumer's principal residence that have a fixed rate of interest for an introductory rate which then resets to an adjustable rate); (2) new disclosures be given in connection with ARM loans for which an escrow account will be established; and (3) "monthly statements" be provided for many closed-end residential mortgage loans - the first time TILA has mandated monthly disclosures for closed-end mortgage loans, as it has long required for HELOCs. n14

HOEPA Changes. The MRAPLA also strengthens the provisions that were added to TILA in 1994 by the Home Ownership and Equity Protection Act (HOEPA). These provisions govern high cost loans (also known as HOEPA loans or section 32 loans). n15 The MRAPLA expands the scope of a HOEPA loan which it now labels a "high cost loan" ("HCL") by: including open-end and purchase money loans; lowering the APR threshold (from 8 and 10 percentage points above the applicable index for a first and a subordinate-lien loan, respectively, to 6-1/2 and 8-1/2 percentage points); changing the applicable index which is used to calculate the threshold (from the yield on Treasury securities to the "average prime offer rate"); lowering the points and fees threshold (from 8% to 5% of the total loan amount); expanding the list of items that count as "points and fees"; and adding a third category of high cost loans, *i.e.*, loans that carry prepayment penalties that can be imposed after 6 months or that exceed 2% of the amount prepaid). The MRAPLA also prohibits balloon payments on HCLs and late fees in excess of 4% on HCLs. One helpful change is the addition of two provisions that allow creditors to "cure" an HCL error - one, within 30 days after closing for any "good faith" violation and, two, within 60 days after discovery or notice (but before commencement of any action) of an "unintentional" violation or bona fide error.

New Servicing Requirements.

TILA Amendments. The MRAPLA amends TILA to require that escrow accounts be established on certain loans - those for which it is required by federal or state laws, conforming loans with APRs greater than the comparable average prime offer rate + 1.5 percentage points, and jumbo loans with APRs greater than the comparable average prime offer rate + 2.5 percentage points. It also mandates that, for loans on which escrows are required, the escrow accounts remain in place for at least 5 years after closing. There are also new disclosure requirements in connection with escrow accounts and escrow account waivers. Other servicing provisions establish new mandates for the prompt crediting of payments and prompt responses to requests for payoff quotes, and new requirements that TILA payment schedule disclosures for loans in connection with which escrow accounts are or will be established take into account the amounts that will be required to be paid into escrow each month. n16 TILA penalties could now be triggered by servicing violations, as discussed later.

RESPA Amendments. The MRAPLA also amends section 6 of the Real Estate Settlement Procedures Act ("RESPA") n17 to: (i) impose new restrictions and disclosure requirements for the force-placing of insurance; (ii) prohibit the charging of fees for responding to qualified written requests ("QWRs"); (iii) require servicers to respond to QWRs that ask for information concerning the identity of the owner or assignee of the loan within 10 business days; (iv)

shorten the time frames within which servicers are required to acknowledge receipt of and respond to other types of QWRs, from 20 and 60 days, respectively, to 5 and 30 days, respectively; and (v) require servicers, within 20 days following payoff of a borrower's loan, to refund to the borrower (or credit to the borrower's new escrow account) any monies remaining in the borrower's escrow account. n18

New Appraisal-Related Rules. With respect to every "higher risk" mortgage loan (a non-qualified mortgage with an APR in excess of specified threshold), the MRAPLA amends TILA to require that the creditor obtain a written appraisal that conforms to specified standards (including that it be prepared by a certified or licensed appraiser and be based on a physical inspection of the interior of the property by the appraiser), and a second appraisal (without charge to the borrower) if the loan is used to purchase a property from a seller who bought it at a lower price within the preceding 180 days. For all consumer credit transactions secured by the borrower's principal dwelling, the MRAPLA establishes new appraiser independence safeguards to replace the Home Valuation Code of Conduct; imposes standards for the licensing and registration of appraisal management companies ("AMCs") and new quality control standards for automated violation models ("AVMs"); prohibits use of broker price opinions; requires copies of appraisals be given to borrowers and new notices at time of application concerning borrowers' right to receive such copies; and authorizes the banking regulators to require that AMC fees be broken down on GFEs. n19

Expanded Penalties/Remedies for Non-Compliance

Mortgage Broker/Loan Officer Liability. Section 130 of TILA has for many years provided borrowers with a private right of action to sue "creditors" for damages based on a violation of TILA. n20 The MRAPLA amends TILA to add another potential defendant in actions based on allegations of unlawful steering by enabling borrowers to also sue a "mortgage originator" who engages in such practices. In any such action against a mortgage originator, the consumer may recover his/her actual damages or 3 times the originator's total compensation, whichever is higher. n21

Expanded HOEPA Damages; New Defenses to Foreclosure. The MRAPLA also allows borrowers to recover enhanced HOEPA damages (equal to the sum of all finance charges and fees paid by the borrower) for material violations of the new TILA anti-steering and ability to repay requirements. And it allows borrowers to assert such violations in response to a foreclosure proceeding as a defense by recoupment or set off, *without regard to any limitations period in TILA*. n22 This means that 5 or 10 or 20 years after a loan closes and in response to a foreclosure, the borrower can raise a TILA damages claim as a matter of recoupment by alleging, for example, that the lender did not properly assess the borrower's ability to repay the loan.

Higher TILA Damage Limitation; Longer Period Within Which Borrowers Can Sue. Additionally, the MRAPLA increases the maximum damage award in class actions for TILA violations from \$500,000 to \$1 million. It also extends the limitations period from 1 year to 3 years for private actions alleging violations of TILA § 129 (HOEPA), or new TILA §§ 129B or 129C. n23 However, the MRAPLA excludes creditors and assignees from liability if the borrower is convicted of fraud in obtaining the loan. n24

Higher RESPA Damage Limitation for Section 6 Violations. Finally, the MRAPLA increases the penalties for violating the rules in RESPA § 6 concerning QWRs from \$1,000 to \$2,000 in individual actions and from \$500,000 to \$1 million in class actions. These damage limits do not impact RESPA § 8 referral fee lawsuits.

Where Happens Now?

While economists and other experts can surely debate the causes of our current economic crisis, statistics included in the MRAPLA and quoted at the beginning of this article suggest that the development and marketing of non-traditional and exotic mortgage products and the loosening of underwriting standards that took place during the years leading up to it can be traced to the governmental push beginning in 1995 to expand homeownership. The MRAPLA now encourages lenders to reverse course - to focus on more plain vanilla loans and tighten their underwriting standards - and penalizes those that do not. The risk of this change in direction is that consumers who do

not fall into the highest credit categories (based on income, assets, LTV and credit scores) may find it increasingly difficult to qualify for a mortgage loan, leading to a possible contraction of home ownership and a further deterioration in home values. Obviously aware of this risk, Congress has in fact mandated in the MRAPLA that a study be conducted by the Government Accounting Office "to determine the effects the enactment of [the MRAPLA] will have on the availability and affordability of credit for consumers, small businesses, homebuyers, and mortgage lending." n25 The results of this study should be eagerly anticipated by all concerned.

[Return to Text](#)

n1 P.L. 111-203, *124 Stat. 1376*.

n2 Dodd-Frank § 1491.

n3 *15 U.S.C. § 1601 et seq.*

n4 Dodd-Frank § 1411.

n5 Dodd-Frank § 1411.

n6 Dodd-Frank § 1412.

n7 Dodd-Frank § 1414.

n8 Dodd-Frank § 1414.

n9 Dodd-Frank § 1471.

n10 Dodd-Frank § 941.

n11 Dodd-Frank §§ 1403-1405.

n12 Dodd-Frank § 1405.

n13 Dodd-Frank § 1414.

n14 Dodd-Frank §§ 1418-1420. (Monthly statements are not required in connection with fixed-rate loans, where equivalent information is provided in coupon books.)

n15 Dodd-Frank §§ 1431-1433.

n16 Dodd-Frank §§ 1461-1462, 1464-1465.

n17 *12 U.S.C. § 2605.*

n18 Dodd-Frank § 1463.

n19 Dodd-Frank §§ 1471-1476.

n20 *15 U.S.C. § 1640.*

n21 Dodd-Frank § 1404.

n22 Dodd-Frank §§ 1413, 1416.

n23 These sections include the new anti-steering and ability to repay requirements, as well as any new regulatory restrictions adopted by the FRB or the Bureau of Consumer Financial Protection against "abusive, unfair, deceptive, [or] predatory" acts or practices.

n24 Dodd-Frank §§ 1416-1417

n25 Dodd-Frank § 1421.

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Robert M. Jaworski is a partner in the Financial Services Regulatory Group of Reed Smith, LLP in Princeton, New Jersey. He is a former Deputy Commissioner of the New Jersey Department of Banking, the current Chair of the New Jersey Bar Association's Banking Law Section, the immediate past Co-Chair of the RESPA and Housing Finance Subcommittee of the American Bar Association's Consumer Financial Services Committee and the former Editor of Pratt's Mortgage Compliance letter, a national publication on mortgage compliance issues. Mr. Jaworski provides federal and state compliance and regulatory advice and assistance to banks, mortgage lenders and other consumer financial services providers and regularly assists Reed Smith litigators in defending financial institutions in individual and class actions. He is a frequent speaker before financial institution groups, has authored numerous articles on consumer financial services regulatory issues, and is a regular contributor on real estate topics for several LexisNexis publications, including Real Estate Financing (LexisNexis Matthew Bender) and the LexisNexis Online Emerging Issues Analysis. He is also an educator, having developed and taught courses for mortgage professionals concerning New Jersey and federal mortgage lending law (including NMLS-approved mortgage originator courses) under the auspices of Lenders Resource Development, inc., a company he founded.

Mr. Jaworski would like to thank his partner, Leonard A. Bernstein, Esq., for his most helpful assistance in preparing this Emerging Issues Analysis.

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2 of 79 DOCUMENTS

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Fisher and Khandwala on Attacking Foreclosure Rescue Scams

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Fisher and Khandwala on Attacking Foreclosure Rescue Scams

By Linda E. Fisher and Leena Khandwala

September 17, 2010

SUMMARY: There is more than one way to lose a house. Foreclosure rescue scammers can steal the title and equity from your client's home. What are you going to do about it? Linda E. Fisher and Leena Khandwala discuss available legal rights and remedies.

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ARTICLE: 1. The Reason for this Commentary

While mortgage fraud has existed for a long time, the recent rising tide of foreclosures has fueled a proliferation of "foreclosure rescue scams" perpetrated on homeowners in financial distress and desperate to save their homes. n1 With foreclosures increasing, government efforts to stanch them lackluster at best, lenders showing little willingness to modify loans, and a severe lack of affordable legal services, more and more homeowners are falling prey to smooth-talking operators who promise to help them save their homes. Instead, homeowners end up losing the equity they have accumulated in their homes as well as their title, and are left facing foreclosure or eviction. This commentary addresses the nature of the scams themselves as well as legal rights and remedies potentially available to homeowners.

2. How Foreclosure Rescue Scams Work

Scammers employ an aggressive and highly sophisticated system to reach victims, often advertising online and in local publications, using posters on telephone poles and at bus stops, sticking flyers in people's front doors or, most persuasively, directly contacting people whose homes are listed in public foreclosure notices. Sometimes they direct their appeals to specific religious or ethnic groups. n2 Some of them have sophisticated websites that suggest that the companies are affiliated with the government. There are several common variations of the scheme:

Focus of this Commentary: Sale/Leaseback Scam. One particularly pernicious variation is the sale/leaseback program. n3 The scammers offer to pay off the defaulted mortgage if the homeowners will "temporarily" deed the house over to one of the scammers. The homeowners then become "tenants" of the new owner until, as they are assured, their credit improves and they can obtain a refinance. Transferring the title enables an investor opportunities to profit

from the transaction including

- skimming equity by seizing cash back at closing,
- fee packing,
- receiving rents often in excess of the new mortgage payment (or pocketing the payments without making payments on the new mortgage), and
- even reselling the property.

The homeowner has no guarantee that the straw buyer will actually make the mortgage payments, and does not realize that if the straw buyer fails to do so, the home could be foreclosed upon. Further, despite the provision to buy back the property, the terms are generally so onerous that buyback becomes impossible. Meanwhile, the scammer almost invariably defaults on the new mortgage, leaving the homeowner to face eviction. These conspiracies often involve a number of actors, including mortgage brokers, straw buyers, appraisers, and lawyers.

Related to Sale/Leaseback Scam: Signing Over Deed. In a related variation, homeowners are led to believe that they are signing documents for a new loan to make the mortgage current, when in fact, they end up signing over the deed to their homes in exchange for the "rescue" loan. n4

Common Scheme: Rescuers Scam. Another common scheme involves "rescuers," often affiliated with lawyers, who charge high upfront fees (often up to \$3,000) with promises to help homeowners obtain mortgage modifications, or other concessions from the lender. n5 Homeowners are told not to contact their lender, lawyer, or credit counselor, but to let the rescuer handle everything. Rescuers may abscond with the money altogether, or at most make a few cursory phone calls and fill out some paperwork, but fail to do more than a trained housing counselor could do. The homeowner not only loses money that he or she could ill afford, but also valuable time to negotiate with the bank or file bankruptcy. Sometimes, the scammers may even ask homeowners to make all mortgage payments directly to them, disappearing after collecting a few months of payments that never make it to the lender.

Becoming More Common: Short Sales Scam. A new scam involving short sales is becoming more common. In one variation, a real estate broker and scammer/homebuyer conceal the true sale price from the homeowner, allowing them to pocket the difference between the higher actual sale amount and the homeowner's expectation of a lower price. n6

3. Potential Legal and Equitable Claims, Defenses, and Remedies of Defrauded Homeowners

A typical foreclosure rescue case involves a wide range of actors. Homeowners may be able to assert multiple legal claims against them, depending on the nature of the scheme and their particular circumstances. Before that occurs, though, homeowners in judicial foreclosure states n7 frequently must seek to vacate a default foreclosure judgment entered against the straw buyer and to intervene in the reopened foreclosure. If they can demonstrate the existence of potentially meritorious defenses to the foreclosure, courts may grant these motions. At that point, the homeowner may also be able to bring germane third-party claims against the scammers and their confederates. n8 Unfortunately, one major practical difficulty is that the scammers themselves frequently have disappeared or are judgment-proof; this is often the case with other third-parties, such as mortgage brokers and appraisers, as well. In addition, liability of the scammers generally will only affect the foreclosure itself if the plaintiff bank had notice of underlying fraud or was otherwise not a *bona fide* purchaser or holder-in-due-course.

Below, this commentary explores some legal and equitable claims and remedies that may apply to foreclosure rescue situations. Note that this list is not exhaustive, nor does it address the possible vicarious liability of other parties. n9 As mentioned above, many of these claims have particular relevance to the sale/leaseback scheme:

a.) Potential Claims and Remedies Against the Straw Buyer and Other Scammers:

Equitable mortgage: under this theory, the sale to the straw buyer may constitute an equitable mortgage, a type of equitable lien. n10 It is an ancient rule that a deed, although absolute on its face, will be treated as a mortgage if the

parties intended it to secure a debt. n11 In other words, an equitable mortgage is a transaction that has the intent, but not the form, of a mortgage n12 "Equity gives effect to the transaction as a mortgage because the conveyance was intended as security only, and enforcement of it as such is necessary to prevent forfeiture." n13 This is typically a fact-based determination, but an agreement to reconvey the property is significant to a finding of equitable mortgage.

Other factors include:

- (1) whether the transaction documents use the terms "debt," "security," or "mortgage";
- (2) a large disparity between the value of the property and the loan amount;
- (3) the scammer's representations concerning the transaction;
- (4) whether the owner attempted to sell the property on the open market;
- (5) whether the sale price was negotiated between the parties;
- (6) whether the seller continues to reside in the property, perhaps with a lease;
- (7) a disparity in bargaining power between the parties, including lack of legal representation of the seller; and
- (8) the financial distress of the homeowner. n14

Federal consumer credit protection statutes: Once it is established that the transaction constituted an equitable mortgage, the straw buyer can be held liable as a mortgagor under federal statutes including the Federal Truth in Lending Act ("TILA") n15 and the Home Ownership and Equity Prevention Act ("HOEPA"), both of which apply to equitable mortgages. n16 Violations of TILA and HOEPA can entitle the homeowner to rescind the transaction, n17 to obtain statutory damages of up to \$4,000, and to recover costs and attorneys' fees. Additionally, homeowners may assert violations of the federal Credit Repair Organizations Act, which prohibits anyone from making false statements to consumer reporting agencies or persons providing credit. n18

State unfair and deceptive acts and practices statutes and anti-predatory lending legislation: Homeowners may also assert claims under state unfair and deceptive acts and practice statutes, such as the New Jersey Consumer Fraud Act. n19 In *O'Brien v. Cleveland*, a New Jersey bankruptcy court held that a mortgage rescue scam is an unconscionable commercial practice in violation of the New Jersey Consumer Fraud Act, entitling homeowners to treble damages from the straw buyer, attorneys fees, and an order voiding the deed. n20 In appropriate cases, homeowners may also assert claims under consumer credit protection or anti-predatory lending statutes, such as the New Jersey Home Ownership Security Act of 2002 ("HOSA"), which regulates home loans and high-cost home loans, and prohibits practices such as financing credit insurance, encouraging default, or charging excessive late fees. n21 Remedies for violations of HOSA include statutory damages equal to finance charges plus up to 10% of the amount financed, punitive damages and costs and attorneys fees. n22

Note: Most of these claims run solely against the equitable mortgagee (the rescue scammer), rather than a new lender to whom the scammer gave a mortgage on the property - often the foreclosure plaintiff - unless the lender was not a *bona fide* purchaser, holder or holder-in-due-course of the mortgage obligation. The TILA, however, imposes assignee liability for statutory violations that were apparent on the face of the disclosure documents. n23 The HOSA also contains a limited assignee liability provision. n24

Common law: The homeowner can also seek to void the transaction on grounds of common law fraud, unconscionability, unjust enrichment, adhesion, breach of contract, and/or violations of various consumer protection laws. As above, however, these claims run against the scammers and result in voiding the initial transaction, but leave intact any subsequent transfers, unless the lender was not a *bona fide* purchaser, holder-in-due-course of the note, or

otherwise vicariously liable.

Quiet Title: A court may employ its equitable powers to determine and settle claims to real property when the scammers have gained legal title to the property. n25 In foreclosure rescue scam cases, two ownership interests - legal and equitable - exist simultaneously in the same property. The equitable interest vests in the defrauded homeowner. n26 The equitable interest is the *real* ownership interest, whereas the legal interest is nothing more than a shadow that follows the equitable interest. n27 The remedy of quieting title belongs to that class of remedies in which "a primary right of property, estate, or interest is *directly* declared, established, or acquired or enforced; and [it] often consist[s] in the conveyance by defendant of a *legal* estate, corresponding to the complainant's *equitable* title." n28 The most common form of relief in these suits is "to remove clouds on title by cancelling the instrument which causes the cloud . . ." n29 Relief may also be awarded to the complainant by enjoining an act which would cause a cloud, "which [act], for some reason, would be invalid." n30 All parties with a potential claim to the property (*i.e.*, the foreclosing mortgagee, any assignees and all lienholders) must be joined in the action or they will not be bound by the determination. n31

4. Potential Claims Against Other Third Parties

Mortgage broker: Mortgage brokers are also often involved in sale/leasebacks, and may have been complicit in facilitating the fraudulent transactions. n32 In some instances, conspiracy claims against the scammers, brokers, and other parties are appropriate; in other instances, the broker may have been acting as an agent of the scammers. In addition, state statutes govern the responsibilities of loan brokers. n33 Frequently, brokers also have arrangements with appraisers who may issue inflated appraisals in order to obtain larger mortgages.

Closing agent, seller's or buyer's attorney: Attorneys may play an integral role in foreclosure rescue scam cases, in a fashion that is less than transparent to the homeowner. Homeowners rarely sign retainer agreements, although they generally pay for legal services as part of their closing costs. In some instances, an attorney-client relationship can be inferred, giving rise to a duty of care to the homeowner. In addition, courts have held that even if there is no direct attorney-client relationship, liability may arise from the lawyer's duty to a non-client who foreseeably could have relied on the lawyer, and from a lawyer's ethical obligation to refrain from participating in an illegal or fraudulent transaction. n34 To establish liability under this theory, the lawyer must have had actual or constructive notice of the underlying scheme, and have been either complicit in it or failed to take steps to prevent it from happening.

Originating or assignee lender: In certain instances, a lender or its assignee may be liable for lending to the straw buyer if it had inquiry notice of the underlying rescue fraud or otherwise was not a legitimate holder or holder-in-due-course of the obligation. n35 As mentioned above, certain statutes also contain assignee liability provisions.

5. Potential Defenses in a Foreclosure

(i) Homeowner defenses:

- **Fraud in the Factum:** Depending on the facts of the individual case, the homeowners may assert a *fraud in the factum* defense, alleging that because the essential terms of the loan were concealed from them or misrepresented, and that they had no reasonable opportunity to discover the fraud, the transaction was void *ab initio*. n36 This could arise in a case where the homeowner is told that s/he is signing a loan document when in fact it is a deed, or when the buyback terms and conditions have been concealed. Since no good title or valid encumbrance can arise from a deed that is void *ab initio*, the subsequent mortgage between the scammer and the new lender is also void.
- **Common law and consumer fraud grounds for voiding the transaction:** The transaction may be voidable if it was based on fraud in the inducement, unconscionability, unjust enrichment, adhesion, breach of contract, and violations of various consumer protection laws. However, an encumbrance secured by a voidable deed can survive, offering no recourse against the lender unless the lender was not a *bona fide* purchaser, or had unclean hands. n37
- **Unclean hands:** Following the traditional maxim "he who comes into equity must come with clean hands," courts

permit this defense when the party engaged in "evil practice or wrong conduct in the particular matter or transaction in respect to which judicial protection or redress is sought." n38 If the lender knowingly participated in the unlawful mortgage transaction, it may be precluded from foreclosing.

(ii) Lender defenses:

■ **Bona fide purchaser:** The homeowner's equitable interest is not binding on third parties that are "*bona fide* purchasers for value" because they took the property "free and clear from all claims except those of which [they had] notice." n39 Notice may be actual or constructive; it "contemplates the existence of circumstances or facts either known to a prospective purchaser or of which he is chargeable with knowledge which imposes upon such purchaser the duty of inquiry." n40 Notice of the homeowner's true interest in the property, the fraudulent nature of the transaction, or negligent underwriting that facilitated the fraudulent scheme could suffice to overcome this defense. n41 In *Davis v. Elite Mortgage Services*, an Illinois case, the plaintiff homeowner entered into a foreclosure rescue sale-leaseback transaction with a scammer. n42 The scammer subsequently sold the property, in which Plaintiff still lived, to another third-party, who in turn financed it with a mortgage from a third-party bank. n43 The bank claimed it was a *bona fide* purchaser for value and lacked notice of the Plaintiff's claim of title. n44 But the court found "signposts of plaintiff's possession" sufficient to put the bank on constructive notice of another claim to the property. n45 A duty of inquiry arose because the bank had "knowledge of facts inconsistent with the mortgagor's claim or 'facts which would make a prudent person suspicious.'" n46 Inconsistencies in the loan file were similar to the "red flags" in other foreclosure rescue scams (inconsistencies in data, disputes as to possession of the property, inflated appraisal value, etc.) The court therefore denied the *bona fide* purchaser defense. n47 As a result, equitable remedies would extend to the lender as well.

■ **Holder-in-Due-Course:** In a typical rescue case, a foreclosure action has been brought against the straw buyer by a securitized trust that acquired the mortgage and note from the originating lender or an intermediary. When the foreclosure plaintiff is a trust or other assignee of the original lender, it may assert holder-in-due-course status under Article III of the U.C.C. permitting it to take the obligation free of underlying claims and defenses. n48 The borrower may respond that the plaintiff is not a holder in due course because it had notice of default or underlying fraud. n49 In addition, the trust is not a holder in due course if it was not a valid holder of a negotiable instrument in the first place. n50 A close connection between the trust and the originator - defined as sufficient to create an agency relationship - may defeat holder-in-due-course status, n51 as will a finding of civil conspiracy, joint venture, or aiding and abetting the scammers. n52 Further, under the shelter doctrine, a transferee acquires the holder status of its transferor; if the transferring lender was not a holder in due course, neither is the transferee. n53

■ Further, even if the trust is a holder-in-due-course, it remains liable for real defenses such as *fraud in the factum*. n54

6. Constructive Trusts and Unwinding Foreclosure Rescue Scams

A range of traditional equitable remedies is available to a court to unwind rescue scams; certain of these, such as equitable mortgage, were discussed above. While legal remedies are characterized by their fixed nature and technical rules that govern such relief, equitable remedies "are distinguished by their flexibility, their unlimited variety, their adaptability to circumstances, and the natural rules which govern their use." n55 In fact, there is "no limit to their variety and application; the court of equity has the power of devising its remedy and shaping it so as to fit the changing circumstances of every case and the complex relations of all the parties." n56 Thus, with adaptation to this new factual context, ancient remedies can directly address foreclosure rescue situations.

Constructive trust is a restitutionary remedy designed to prevent unjust enrichment, imposed in the interests of justice. Restitution is an appropriate form of relief when monetary damages would be inadequate. n57 The unifying theme of the restitutionary tools in a court's equity toolbox is the prevention of unjust enrichment. n58 Restitution "springs from the simple fact that the recipient has received a benefit for which he has not responded with a *quid pro quo*." n59 A constructive trust is an implied trust, not based upon the manifest intentions of the parties, sometimes arising even "directly contrary to the intention of the one holding the legal title." n60 The court may impose such a trust "in the interests of justice, to redress a wrong or to prevent unjust enrichment." n61 A court of equity should be concerned not with "the method by which the defendant enriched himself, but the fairness and workability of the

judicial decree." n62

a.) Fraud and Unjust Enrichment

Restitutionary remedies such as constructive trust arose to address circumstances in which a "plaintiff who was led [to] convey his land by the fraud of the defendant had no remedy in ejectment." n63 If a defendant fraudulently acquired title to plaintiff's property, although he could not be ejected because he had title, in equity he could be forced to reconvey the property. n64 The doctrine acts not upon the property at stake, but upon the persons of the fraudsters. The court of equity declares the fraudfeasor a constructive trustee and then compels him, as trustee, to transfer the property to the homeowner - the beneficiary of the constructive trust. n65 This doctrine may impose further remedies upon the remaining parties as well: If a foreclosure plaintiff lender is liable for disregarding warning signs of underlying fraud or other conduct, or is not a *bona fide* purchaser or holder-in-due-course, it could be unjustly enriched by foreclosing on the property. The equity court may, among other possibilities, rescind the mortgage.

b.) Unjust Enrichment as the Result of Duress

Enrichment due to duress or other compelling circumstances is another ground for imposition of a constructive trust. n66 If consent to a transaction was brought about by duress, then the transaction is only voidable - not void. n67 In mortgage fraud cases, the duress was not imposed by the scammer - rather the victim was already in a state of duress when the scammers presented their rescue schemes to their prey. Hence, restitution is only available if the scammer, or any other defendant, knew of the duress of their victim. n68 The act or threat that overcomes the will of the victim need not be "wrongful" or unlawful. n69 Circumstances constitute duress if a victim was induced to do what he would not have done absent the circumstances constituting the duress. n70 "The age, sex and capacity of the one coerced has to be considered, as well as the relationship of the parties." n71 Thus, even where one may have the legal right to do something, the exercise of that right in certain situations can be unconscionable and constitute duress. n72

The threatened harm can also involve the deprivation of land. n73 Although financial pressures alone are insufficient to warrant setting aside a transaction for duress, a finding of duress is warranted if the defendant was aware of the plaintiff's "economic plight and deliberately took advantage of it." n74 Therefore, because the victims in these mortgage fraud cases chose the less unpleasant of two alternatives - conveying the property to the scammer with the hope they could later buy the property back over losing the property in the imminent foreclosure - the transactions should be voidable. Title to the property should be revested in the original homeowners.

c.) The Constructive Trust Follows the Property

One of the great benefits of the constructive trust remedy is that it can be "traced." The imposition of a constructive trust is only warranted "when property in some form can be identified as belonging in good conscience to the plaintiff [homeowner]." n75 However, restitution allows a complainant "to follow property into its product." n76 For instance, not only could a trust be imposed on the original scammer, but also on third parties who purchase from the fraudfeasor. n77 For example, "if A fraudulently induces plaintiff to sell property, and then A re-sells it to B, the plaintiff may be permitted to impose the constructive trust upon the property in the hands of B, if he is not a *bona fide* purchaser." n78 Following equitable principles, only if a mortgagee acted in good faith in issuing a loan to the scammer and without notice of the underlying fraud on the homeowner, and is *equally innocent*, could the mortgagee have a legitimate stake in the property. n79 The constructive trust also creates a preference for the complainant against other creditors of the scammer who would otherwise be entitled to enforce judgments against the scammer by forcing a sale on the property. n80

d.) Proposing a Workable Framework for the Imposition of a Constructive Trust

In order to do justice, a court should apply the following framework in rescue scam cases.

- First, the court should determine whether the original homeowners conveyed the subject property under an inducement of fraud, mistake, duress, etc. The intent of the parties to form a trust relationship is not a factor for the

court's consideration.

- Second, if grounds exist to warrant imposition of a constructive trust, the court must determine whether the scammers were unjustly enriched by transfer of the property. Homeowners should argue first that the scammers' fraudulent acquisition of the subject property led to the unjust enrichment of the scammers (or the scammers' successors) at the expense of the original homeowner(s). n81 Additionally, if the mortgagee bank - or its assignee - is permitted to foreclose on the property, then the court would be rewarding the bank for having issued an illegal mortgage and ratifying the bank's reckless disregard of the risk of mortgage fraud; this would unjustly enrich the bank, also at the homeowner's expense.

- Third, after concluding that unjust enrichment exists, the court should impose a constructive trust and declare that the scammers had acquired legal title to the property subject to the superior equitable claim of the original homeowners. n82 The court should also impose the constructive trust relationship on subsequent purchasers and mortgagees who had notice of the fraud and either perpetrated or enabled it. All such parties would be deemed constructive trustees, holding the property for the benefit of the original homeowner. "[A] valid claim to restitution from property may be asserted against transferees of the property (and its traceable product) until the property comes into the hands of a *bona fide* purchaser." n83

- Fourth, the court should issue an injunction directing the scammer to surrender the property to the original homeowner and revesting title in the original homeowner. n84 Following the doctrine of equitable lien, the revesting of title could be conditioned on payment to other parties for acts done that benefited the homeowner while the property was held in trust. n85

- Fifth, if not required as a condition precedent to the revestment of title in the complainant, and to make sure the parties are returned to the *status quo ante*, an equitable accounting should be conducted. n86 However, where the basis for the constructive trust is wrongful conduct on the part of the person who holds legal title (*i.e.*, the fraudfeasors), any claim the holder makes for unrequested benefits conferred on the equitable owner ought to be rejected. n87 For instance, if B *fraudulently* acquired Blackacre from A and made improvements to the property at B's own expense, which increased the value of the property over its worth when A conveyed it to B, B would *still* have no claim in restitution for the value he added to the A's interest in the property. n88 But because the banks' conduct may not be sufficiently wrongful to warrant withholding of reimbursement of benefits conferred on the complainant, the complainant could still be liable for the benefits he or she received. These may include money the bank expended to pay off the homeowner's original mortgage. The bank may also be entitled to a credit for the reasonable use and occupancy (rent) for the amount of time the homeowner was in possession of the property without having made any rental or mortgage payments.

7. Conclusion

The main objective of equitable remedies is to do justice to the parties; the court is therefore given sufficient flexibility to craft appropriate orders in situations - such as foreclosure rescue scams - where vulnerable parties are taken advantage of. While the methods of these scams vary, a constant theme runs through them: scammers want to take advantage of people they know are at risk of losing their homes, they promise a lot while delivering little, and after wrestling away legal title to the property, they drain the equity in the property as quickly as possible. In these circumstances, legal remedies of damages, while part of the solution, are not up to the task of ensuring justice for the original homeowners. A combination of legal and equitable remedies can allow justice to prevail in the end.

[Return to Text](#)

n1 See generally *Foreclosure Rescue Scams*, in *Foreclosures*, National Consumer Law Center, Chapter 15 (2007). See also Melissa Huelsman, *Foreclosure Rescue Scam Litigation*, in *Real Estate Financing*, Ch. 5B (LexisNexis Matthew Bender); Linda E. Fisher, *Target Marketing of Subprime Loans: Racialized Consumer*

Fraud and Reverse Redlining, 18 Brooklyn J. of Law & Pol'y. 101, text accompanying notes 86 -- 93 (2009), available at ssrn.com; Fed. Bureau of Investigation, 2008 Mortgage Fraud Report "Year in Review" (2009), available at http://www.fbi.gov/publications/fraud/mortgage_fraud08.htm#3 (describing nature and incidence of current fraud schemes).

n2 See Fisher, *supra* note 3, text accompanying notes 49 - 93.

n3 See Foreclosures, *supra* note 3, at § 15.2.2.

n4 *Id.* at § 15.2.1.

n5 *Id.* This variation may also be labeled the "phantom help" scheme.

n6 See *id.* at § 15.2.5 (2009 Supplement).

n7 This commentary does not address procedures in non-judicial foreclosure states.

n8 For instance, New Jersey Court Rule 4:64-5 permits the joinder of germane counterclaims and third-party claims. Only germane counterclaims and cross-claims may be pleaded in foreclosure actions without leave of court. Leave may be granted where the ultimate disposition requires resolution of collateral issues. See *Sovereign Bank, FSB v. Kuelsow*, 297 N.J. Super. 187, 197-198 (N.J. Super. Ct. App. Div. 1997).

n9 In particular, this commentary does not address in detail the specific issues that arise when the foreclosure plaintiff is the trustee of a securitized trust to which the scammer's mortgage has been assigned. Those complex issues are beyond the scope of this piece.

n10 Henry L. McClintock, *Handbook of the Principles of Equity* § 118 at 319 (2d ed. 1948).

n11 Garrard Glenn, *Mortgages, Deeds of Trusts, and Other Security Devices as to Land* § 11 at 53 (1943).

n12 Leonard A. Jones, *A Treatise on the Law of Mortgages of Real Property* § 225 (8th ed. 1928). *But see* McClintock, *supra* note 12, § 119 at 323 ("A conveyance which is in the form of an absolute transfer of title, but which was intended by the parties only as security, and is therefore treated in equity as a mortgage and not a deed, is also sometimes spoken of as an equitable mortgage, but it is manifestly based on a different principle, since the doctrine of equity here operates to cut down the legal rights transferred by the instrument instead of creating a security as is the case with other equitable mortgages.") (footnote omitted).

n13 William F. Walsh, *A Treatise on Mortgages* § 8, at 51 (1934). *See* McClintock, *supra* note 12, § 119 at 320 ("Generally, equity will impose a mortgage on land whenever it finds an intent of the parties to that effect, though that intent has not been expressed in the form required to create a valid mortgage at law; where only a security transaction is intended, it will consider an absolute deed to be a mortgage.").

n14 *O'Brien v. Cleveland (In re O'Brien)*, 423 B.R. 477 (Bankr. D.N.J. 2010). *See also* *Carter v. Second Chance Program, Inc., No. 06 CH 26787* (Ill. Ch. Ct., Cook County Dec. 23, 2008) (holding that a transaction documented by a deed from the homeowner to the rescuer, a lease and an option to repurchase, viewed in light of the intent of the parties, constituted an equitable mortgage, entitling the homeowner to remedies for TILA and HOEPA violations).

n15 15 U.S.C. § 1601, *et seq.*, *see also* Regulation Z, 12 C.F.R. § 226.

n16 15 U.S.C. § 1639 (added to TILA in 1994); *see also* 12 C.F.R. §§ 226.31, 226.32, 336.34 incorporating HOEPA into Regulation Z). To qualify as a creditor under HOEPA, the transaction has to meet specific requirements: the total points and fees payable by the consumer at or before closing must exceed the greater of 8% of the total loan amount or \$400; or the Annual Percentage Rate at consummation of the transaction must exceed by more than 10 % points the yield on treasury securities having comparable rates of maturity on the fifteenth day of the month immediately preceding the month in which the application for extension of credit is received by the creditor. 15 U.S.C. § 1602 (aa); *see also* 12 C.F.R §§ 226.2(a)(17), 226.32.

n17 In order to rescind the transaction under TILA, some courts require that the homeowner has to be ready to make a tender of the amount due. This is calculated as follows: Consideration received at closing by the homeowner (generally the amount of the original mortgage paid off by the new buyer plus any cash paid to the

homeowner at the closing) LESS the amount of statutory damages due to the homeowner for TILA and/or HOEPA violations and the finance charges paid on the loan (generally the rental payments made by the homeowner). *See e.g., Carter v. Second Chance Program No. 06 CH 26787* (Ch. Ct., Cook County, Ill Dec. 23, 2008).

n18 15 U.S.C. § 1679(b). A plaintiff can state a claim under this statute even if the defendant is not a credit repair organization as defined by 15 U.S.C. § 1679(a). *Whitley v. Taylor Bean & Whitaker Mortgage Corp.*, 607 F. Supp. 2d 885 (N.D. Ill. Apr. 20, 2009).

n19 N.J. Stat. Ann. § 56:8-2. *et seq.* For additional discussion of anti-predatory lending statutes, *see* Real Estate Financing, ch. 5A, *Mortgage Fraud Legislation* (LexisNexis).

n20 *O'Brien v. Cleveland* (*In re O'Brien*), 423 B.R. 477 (Bankr. D.N.J. 2010).

n21 N.J. Stat. Ann. § 46:10B-29. For a discussion of additional anti-predatory lending statutes, *see* Real Estate Financing ch. 5A, *Mortgage Fraud Legislation* (LexisNexis).

n22 *See id.*

n23 15 U.S.C. § 1641 (a).

n24 N.J. Stat. Ann. § 46:10B-27(b).

n25 *See* Melissa Huelsman, *Foreclosure Rescue Scam Litigation*, in Real Estate Financing, Ch. 5B § 5B.02[1][e](LexisNexis Matthew Bender).

n26 John Norton Pomeroy, Jr., *A Treatise on Equity Jurisprudence, as Administered in the United States of America; Adapted for All the States, and to the Union of Legal and Equitable Remedies Under the Reformed*

Procedure § 147 at 178 (4th ed. 1918).

n27 *Id.* § 147 at 178-79.

n28 *Id.* §171 at 214 (third emphasis added).

n29 *Id.* § 198 at 532.

n30 *Id.* at 532-33.

n31 N.J. Stat. Ann. § 2A:62-13.

n32 See U.S. Dept. of Housing and Urban Development, Office of Policy Development and Research, *Report to Congress on the Root Causes of the Foreclosure Crisis* 39-41 (Jan. 2010) (noting high incidence of broker involvement in mortgage fraud).

n33 *E.g.*, N.J. Stat. Ann. § 17:10B-2 (prohibiting false or misleading information in connection with the offer or sale of lender or loan broker services, notwithstanding the absence of borrower reliance).

n34 In *O'Brien v. Cleveland*, the court found that the attorney who had represented the straw buyer and acted as settlement agent (for which he was paid by the homeowners) was liable to the homeowners despite the fact that he was not their lawyer. The court found that the lawyer had facilitated the fraudulent scheme, and violated his duty to withdraw as soon as the nature of the transaction became known to him. The court also found that the lawyer had violated his ethical duties to provide accurate information on the closing documents, and was therefore liable to the homeowners in the amount of the increased debt encumbering their home. The court finally found that the attorney was liable for conspiracy because he knew or should have known of the fraudulent scheme and was therefore jointly liable for damages suffered by the homeowners. *O'Brien v. Cleveland* (*In re O'Brien*), 423 B.R. 477 (Bankr. D.N.J. 2010).

n35 *E.g., Howard v. Diolosa*, 241 N.J. Super. 222 (N.J. Super. Ct. App. Div. 1990).

n36 U.C.C. § 3-305(2)(c), cmt. 7, 2 U.L.A. 241 (1977), *see* Restatement (Second) Of Contracts § 163 and cmts. a-c; Farnsworth § 4.10, at 235.

n37 The law is explicit that bona fide purchasers are protected against equitable remedies sought by homeowners. The Restatement Of Restitution, § 174, Comment c says that the "holder of a negotiable instrument takes it free of equities if he pays value and takes it in good faith even though he was negligent in not knowing of the equities." *See also Haley v. Corcoran*, 659 F. Supp. 2d 714, 722 (D. Md. 2009) (a third party grantee is presumed to be acting in good faith and this presumption can be overcome only by showing that the grantee had knowledge of "suspicious circumstances" that would give rise to a duty to inquire into the previous transactions involving the property).

n38 *Heuer v. Heuer*, 152 N.J. 226, 238 (N.J. 1998).

n39 *Daniels v. Anderson*, 624 N.E.2d 1151, 1156 (Ill. App. Ct. 1993).

n40 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052 (N.D. Ill. 2009); *quoting Burnex Oil Co. v. Floyd*, 245 N.E.2d 539, 542-43 (Ill. App. Ct. 1969).

n41 *See, e.g., Howard v. Diolosa*, 241 N.J. Super. 222, 234 (N.J. Super. Ct. App. Div. 1990) (creating a duty to investigate if there were warning signs of underlying fraud: "If a . . . lienor is faced with extraordinary, suspicious and unusual facts which should prompt an inquiry, it is equivalent to notice of the fact in question."); *see also Mathurin v. Lost & Found Recovery, LLC*, 854 N.Y.S. 2d 629 (N.Y. Sup. Ct., Kings County Feb. 18, 2008) (a "lender underwriting a mortgage has a duty to investigate and ascertain the economic status of the purchaser/mortgagor and whether the purchaser/mortgagor may be committing a fraud against the seller in the underlying transaction.").

n42 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1054 (N.D. Ill. 2009).

n43 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1054 (N.D. Ill. 2009).

n44 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1056 (N.D. Ill. 2009).

n45 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1056 (N.D. Ill. 2009).

n46 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1056 (N.D. Ill. 2009) quoting *In re Ryan v. Continental Assurance Co.*, 851 F.2d 502, 511 (1st Cir. 1988) (emphasis added).

n47 *Davis v. Elite Mortg. Servs.*, 592 F. Supp. 2d 1052, 1058 (N.D. Ill. 2009).

n48 More specifically, under U.C.C. § 3-302, five conditions must be met to establish holder-in-due-course status. One must be: 1.) a holder; 2.) of a negotiable instrument; 3.) for value; 4) in good faith; and 5) without notice of certain problems with the instrument, such as fraud.

n49 See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Financing of Predatory Lending*, 75 *Fordham L. Rev.* 101, 115 (2007).

n50 The criteria for negotiable instruments are set forth in U.C.C. § 3-104(a). A more complete explanation of these requirements is beyond the scope of this commentary, but is fully elaborated in the multi-volume treatise White & Summers, *Uniform Commercial Code* (6th ed. 2010).

n51 Engel & McCoy, *supra* note 51, at 116.

n52 See Christopher L. Peterson, *Predatory Structured Finance*, 28 *Cardozo L. Rev.* 2185 (2007).

n53 U.C.C. § 3-203(b): Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder-in-due-course, but

the transferee cannot acquire rights of a holder-in-due-course by a transfer, directly or indirectly, from a holder-in-due-course if the transferee engaged in fraud or illegality affecting the instrument.

n54 See U.C.C. § 3-305 for a list of real - as opposed to personal - defenses.

n55 Pomeroy, *supra* note 28, § 109 at 122 (4th ed. 1918).

n56 *Id.* § 109 at 122-23 (footnote omitted).

n57 Norman Jay Itzkoff, *Introduction*, in *Dealing with Damages* 3 (Norman Jay Itzkoff ed. 1983).

n58 Graham Douthwaite, *Attorney's Guide to Restitution* § 1.1 at 7 (1st ed. 1977).

n59 *Id.*

n60 Pomeroy, *supra* note 28 § 155 at 190.

n61 Austin Wakeman Scott & William Franklin Fratcher, *The Law of Trusts*, § 2.1 (4th ed. 1987). *See also* Pomeroy, *supra* note 28 at § 151 at 185, 189 (both resulting and constructive trusts are implied trusts).

n62 Dan B. Dobbs, *Handbook on the Law of Remedies: Damages-Equity-Restitution* § 4.3 at 246 (1st ed. 1973).

n63 *Id.* at 240.

n64 *Id.*

n65 Comment e to the Restatement (Second) of Trusts, § 1 describes a constructive trust as follows: [It is] a relationship with respect to property subjecting the person by whom the title to the property is held to an equitable duty to convey it to another on the ground that his acquisition or retention of the property is wrongful and that he would be unjustly enriched if he were permitted to retain the property. George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* § 471 at 3 n.1 (revised 2d ed. 1978).

n66 Douthwaite, *supra* note 60, § 3.1, at 85.

n67 *Id.*

n68 *See id.* at 86.

n69 *Id.* at 87, § 3.2, at 91.

n70 *Id.* § 3.1 at 87.

n71 *Id.*

n72 *Id.* § 3.2, at 92.

n73 *Id.* §3.2, at 91.

n74 *Id.* at 95 (footnote omitted) (discussing the setting aside of an accord and satisfaction in case of duress).

n75 *Id.* § 4.3 at 242 (footnote omitted).

n76 *Id.* (citing Restatement of Restitution § 202 (1937)). *See also* Bogert, *supra* note 67, at 4-5.

n77 Dobbs, *supra* note 64, at 241.

n78 *Id.* at 241-42 (footnote omitted).

n79 *Cf. id.* at 245. Some courts, however, have been willing to extend the trust beyond bona fide purchasers based on the rationale that the innocent defendant would not have received the property or interest but for the actions of the original wrongdoer. *See, e.g., Pope v. Garrett*, 211 S.W.2d 559 (Tex. 1948) (constructive trust which is imposed on the wrongdoer in favor of the person who holds the equitable interest, shall also "extend to the [legal] interests of the heirs who had no party in the wrongful acts."); *Rogers v. Rogers*, 473 N.E.2d 226 (N.Y. 1984) (imposing a constructive trust on life insurance proceeds paid in violation of separation agreement, even though the designated recipient was innocent and without notice).

n80 *See* Dobbs, *supra* note 64, at 244-45.

n81 Restatement (Third) Of Restitution & Unjust Enrichment § 55 cmt. b (Tentative Draft No. 6, 2008).

n82 *See id.*

n83 *Id.* § 55 cmt l.

n84 *See id.* § 55 cmt b.

n85 Bogert, *supra* note 67, § 472 at 63.

n86 Restatement (Third) of Restitution & Unjust Enrichment § 55 cmt. b (Tentative Draft No. 6, 2008). "A general accounting for costs incurred and benefits conferred on either side of the transaction . . . is traditionally described as an incident of the rescission remedy, the stated objective being the return of the parties to the status quo ante." *Id.* § 27, cmt a. Equity may require an accounting when fashioning relief without it would unfairly result in a windfall to the complainant. In addition, where there have been both "receipts and payments by both parties for the account of the other," an accounting is appropriate. McClintock, *supra* note 12, § 202 at 540 (footnote omitted).

n87 Restatement (Third) Of Restitution & Unjust Enrichment § 55 cmt k.

n88 *Id.* cmt k. illustration 29.

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Before Seton Hall, Ms. Khandwala received a prestigious fellowship from New Voices - a Ford-funded national leadership development program that helps nonprofit organizations recruit innovative new talent - to work at the Center for Gender and Refugee Studies at U.C. Hastings College of the Law in San Francisco. In this capacity, Ms. Khandwala helped to advance the development of asylum law in the U.S. by identifying and litigating key cases nationwide that had the potential to set precedent for all refugees seeking protection in the U.S. Ms. Khandwala also assisted pro bono attorneys and other advocates with cases on appeal. Ms. Khandwala played an integral role in developing and teaching CGRS's Refugee and Human Rights Clinic, which was launched at U.C. Hastings in 2005. Ms. Khandwala co-authored several CGRS articles published in academic and legal journals, including a piece on the impact of the one-year bar, a statutorily imposed deadline for filing asylum applications. She also contributed to positive coverage of gender asylum issues in other media.

Ms. Khandwala received her J.D., *cum laude*, from Fordham University School of Law in 2004. She was Associate Symposium Editor of the Urban Law Journal, a Stein Public Interest Scholar and a Crowley International Human Rights Scholar.

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3 of 79 DOCUMENTS

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Mills on Foreclosure Tax Issues for Homeowners

2010 Emerging Issues 5289

Mills on Tax Consequences of Foreclosure and Debt Relief from Homeowner's Perspective

By Patricia Hughes Mills

September 1, 2010

SUMMARY: Patricia Hughes Mills discusses the tax consequences when homeowners either lose their homes due to foreclosure or are able to avoid foreclosure by loan modification. Professor Mills includes a checklist of related questions for attorneys to ask distressed homeowner clients.

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ARTICLE: The tax consequences of foreclosures and debt modifications will depend on certain factors, such as whether the loan is recourse or nonrecourse, whether the debt involved is acquisition indebtedness or a home equity loan, and whether or not the property is the taxpayer's principal residence. This article looks at the tax consequences of foreclosure and debt relief from the residential borrower's perspective. Different consequences, not addressed here, will apply to the lender.

In most situations where foreclosure occurs or is threatened, the value of the property has fallen below the amount of the debt. Whether the property owner transfers the property to the lender in lieu of a foreclosure, or the property is sold in foreclosure, the property owner has experienced a transfer of his or her property that will carry tax consequences. n1 In addition, if the borrower is relieved of the obligation to pay the amount of debt that exceeds the property's value, then the borrower may have debt relief. Debt relief is generally taxable income unless certain exceptions apply. n2 Furthermore, the consequences may differ between recourse and nonrecourse loans. It is this potential combination of factors which adds to the complexity in this area. Let's look at several scenarios:

When the principal residence is

- sold in a foreclosure to lender or third party or
- transferred to lender in lieu of foreclosure and
- loan is nonrecourse debt (i.e., borrower is not obligated to pay excess of loan balance over property value),

the debtor is treated the same as if he or she had sold the property to a third party. n3 Thus, gain is measured by

the difference between the sales price of the property and the debtor's basis in the property. n4 Here, the sales price of the property is considered to be the amount of the nonrecourse debt. n5 The property owner is essentially treated as having a taxable exchange of the property for the debt. The property owner thus has gain or loss equal to the difference between the outstanding loan and his or her basis in the property. n6

Example 1: Assume a homeowner purchased a home for \$200,000 with a nonrecourse loan of \$180,000, and no principal payments were made on the loan. When the value of the property falls to \$120,000 and the property is transferred to the lender in lieu of foreclosure, the homeowner is treated as having sold the property for \$180,000 (the amount of the loan) with a basis of \$200,000 (assuming no subsequent adjustments to basis), resulting in a loss of \$20,000.

Example 2: Assume the same facts as above except that the homeowner had refinanced the home during a period when the value of the home had increased substantially. If the outstanding loan is \$250,000 and the basis of the home is still \$200,000, the homeowner will have \$50,000 of gain when the property is transferred in payment of the loan.

There are two elements to focus on for taxpayers in foreclosure - the fact that he or she is being relieved of the obligation to pay the amount of loan in excess of the property's value, and the fact that he or she has a gain or loss on the transfer of the property. In the above scenarios, where the nature of the debt is nonrecourse, however, the entire transaction is treated as a transfer of the property. **Thus, the taxpayer is not considered to have taxable "debt relief."** The consequence in *Example 1* is simply that the taxpayer has a \$20,000 capital loss, and the consequence in *Example 2* is that the taxpayer has a \$50,000 capital gain.

Since these examples assumed that the foreclosure, or transfer in lieu of a foreclosure, involved a principal residence, any loss will be a non-recognized personal loss. Thus, the taxpayer cannot deduct that loss. n7 With respect to a taxpayer who recognizes gain on a foreclosure, there may be relief available if the property is the taxpayer's principal residence. Internal Revenue Code Section 121 allows taxpayers to exclude up to \$250,000 of gain from the sale of their principal residence (\$500,000 on joint returns if certain conditions are met). n8 The benefits of I.R.C. § 121 may only be used once every two years. n9

When the principal residence is

- **sold in a foreclosure to lender or third party or**
- **transferred to lender in lieu of foreclosure and**
- **loan is recourse debt with lender cancelling borrower's obligation to pay excess of loan balance over property value,**

the situation is similar to that discussed above. A taxable transfer has occurred. However, here the "sales price" for the property is not the full loan amount, as it was with nonrecourse debt, but it is the current fair market value of the property where the property is transferred in lieu of foreclosure, or the actual sales price of the property in the case of a foreclosure. n10

Example 3: Using the facts of *Example 1* but where the debt is recourse, the property owner is deemed to sell the property for its fair market value of \$120,000. Since the property owner's basis in the property was \$200,000, the property owner has an \$80,000 loss (which is a non-deductible personal loss if this is a principal residence). However, since the debtor owes the lender \$180,000 but is only paying the lender \$120,000, if the lender cancels the remaining debt obligation, the property owner has \$60,000 of debt relief. This may or may not be taxable income, as discussed below.

Example 4: Using the facts of *Example 2* but where the debt is recourse, the property owner is deemed to sell the property for its fair market value of \$120,000, which, with a basis of \$200,000, still results in an \$80,000 non-deductible personal loss. If the lender forgives the balance of the debt not paid, the debtor will have \$130,000 of

debt relief (\$250,000 debt balance less \$120,000 of the debt paid off by the transfer of the property).

The problem facing taxpayers in this scenario is whether that debt relief will be taxable income. Generally, the discharge of indebtedness is taxable income. n11 However, there are exceptions when the discharge occurs in bankruptcy, when the taxpayer is insolvent, or when the debt is qualified farm indebtedness, qualified real property business indebtedness, or qualified principal residence indebtedness. n12 We will focus here on the exception for qualified principal residence indebtedness; however, if the taxpayer does not qualify for this exception, he or she may be eligible for one of the other exceptions, such as perhaps the insolvency exception. Note that these rules - that discharge of debt is taxable income unless one of these exceptions applies - will also govern taxpayers who have any loan principal reduced through a loan modification.

With respect to a modification of the loan balance (where the taxpayer keeps the home), or a foreclosure where the debt is recourse debt (that is, the taxpayer is personally liable for any deficiency) but forgiven, Congress provided a favorable result for homeowners in the Mortgage Forgiveness Debt Relief Act of 2007 [the "2007 Debt Relief Act"]. n13 As amended by the 2007 Debt Relief Act, I.R.C. § 108 now specifically excludes from a taxpayer's gross income a discharge of qualified debt on a principal residence. n14 Qualified principal residence indebtedness means acquisition indebtedness n15 with respect to a taxpayer's principal residence. n16 A taxpayer is entitled to relief from cancellation of indebtedness income of up to \$2 million of qualified principal residence indebtedness under this provision. n17 Note, however, that the relief provided by the 2007 Debt Relief Act applies to "acquisition" debt as defined in I.R.C. § 163(h)(3)(B), and not to home equity loans (unless those loans are used for substantially improving a principal residence and otherwise fit within the definition of acquisition indebtedness). n18

In the examples above dealing with recourse debt, if the debt is qualified principal residence indebtedness, a transfer of the property in foreclosure or in lieu of foreclosure with accompanying debt relief for the balance resulted in debt relief of \$60,000 in *Example 3* and \$130,000 in *Example 4*, which would not be taxable income if eligible for the I.R.C. § 108 exclusion.

Note that in *Examples 3* and *4*, the "sale" portion of the transaction (fair market value less basis) produced a non-deductible personal loss of \$80,000. The "sale" portion may produce gain if the basis of the residence is less than the current value. For example, if the residence has a basis of \$100,000, assuming the \$180,000 mortgage was still acquisition debt, then the deemed sale of the property for its fair market value of \$120,000 would result in gain of \$20,000. Although it would be rare for acquisition debt to exceed the basis of a residence, acquisition debt could exceed the basis of the property in certain circumstances, such as perhaps where the property basis has been depreciated as partly or formerly business property. In addition to the "sale" portion of the gain, which may be excludable under the principal residence exclusion of I.R.C. § 121, the "relief of indebtedness" portion of the gain (\$60,000 here) may then be excludable under the qualified principal residence debt rules.

Factors Affecting Tax Consequences Checklist

According to the FDIC, nearly one out of every 200 homes will be foreclosed upon. n19 An estimated 2.82 million homes entered foreclosure during 2009, an increase from the estimated 2.28 million foreclosures that occurred in 2008. n20 Each homeowner facing foreclosure, including those who are able to modify their loans and avoid foreclosure, will want to know the tax consequences they will face. As discussed above, many of the factors affecting such consequences are listed below in the form of a checklist of questions to ask your homeowner client.

Determine Basis of the Property:

- What was the purchase price of the residence?
- What is the amount, if any, of any subsequent improvements (not just repairs) made to the property?

Determine the Loan Amount:

- What is the current outstanding balance of the loan(s)?

Determine the Character of the Loan(s):

- When was the loan(s) on the property acquired, and for what purpose?
- Was the loan acquisition indebtedness or was it a home equity loan?
- Does the loan document indicate that the loan is recourse (borrower is personally liable) or non-recourse?

Determine the Fair Market Value of the Property:

- What is the property's current fair market value?

Determine Qualification for Debt Relief Provisions:

- What is the date of the foreclosure or transfer?
- Is the taxpayer insolvent or in bankruptcy?

[Return to Text](#)

n1 A mortgage foreclosure, like a voluntary sale, is a disposition for purposes of the gain or loss provisions of I.R.C. § 1001. *Helvering v. Hammel*, 311 U.S. 504 (1941).

n2 I.R.C. § 61(a)(12) (discharge of indebtedness is included in gross income); I.R.C. § 108(a)(1) (lists the five exceptions where discharge of indebtedness is not included in gross income).

n3 Treas. Reg. § 1.1001-2(c).

n4 I.R.C. § 1001(a).

n5 *Tufts v. Commissioner*, 461 U.S. 300 (1983).

n6 Treas. Reg. § 1.1001-2(c) Ex. 7.

n7 Treas. Reg. § 1.165-9(a).

n8 I.R.C. § 121(b)(1), (2).

n9 I.R.C. § 121(b)(3).

n10 *Rev. Rul. 90-16, 1990-1. C.B. 12.*

n11 I.R.C. § 61(a)(12).

n12 I.R.C. § 108(a)(1)(A) - (E).

n13 *110 P.L. 142*, amending I.R.C. § 108.

n14 This relief from discharge of indebtedness income on qualified principal residence debt is available only for qualified principal residence debt discharged beginning January 1, 2007 and ending before January 1, 2013, and must be reported on Form 982.

n15 Acquisition indebtedness is defined in I.R.C. § 163(h)(3)(B) as any indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, for purposes of the home mortgage interest deduction of I.R.C. § 163(h), provided the debt is secured by the residence. Acquisition indebtedness will also include debt resulting from the refinancing of the original acquisition indebtedness, up to the amount of the refinanced debt.

n16 Principal residence has the same meaning for this purpose as under I.R.C. § 121. I.R.C. § 108(h)(5). Note that the taxpayer can have only one principal residence. Thus, this exclusion will not apply to vacation or

second homes, even though the taxpayer may be able to deduct the mortgage interest on the second home under I.R.C. § 163(h).

n17 I.R.C. § 108(h)(2).

n18 If only a portion of the discharged debt is qualified principal residence indebtedness, the exclusion from income applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. For example, assume a principal residence is secured by indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold in foreclosure for \$700,000 and the balance of \$300,000 of debt is discharged, the taxpayer may exclude only \$100,000 of the amount discharged from income under this provision. The balance of \$200,000 of debt discharge would be taxable income to the taxpayer unless another exception under I.R.C. § 108 applies. H.R. Rep. No. 110-356. Where the taxpayer qualifies for more than one exclusion under § 108, certain ordering rules apply. See I.R.C. § 108(a)(2). For example, the qualified principal residence exclusion will not apply if the taxpayer is in bankruptcy. I.R.C. § 108(a)(2)(A).

n19 http://www.fdic.gov/about/comein/files/foreclosure_statistics.pdf.

n20 *Measuring Progress in U.S. Housing and Mortgage Markets*, FDIC Quarterly 2010 Vol. 4 No. 1; http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_1/FDIC_Quarterly_Vol4No1_Full.pdf.

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4 of 79 DOCUMENTS

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Eminent Domain for Urban Revitalization Five Years After Kelo

2010 Emerging Issues 5280

Steven J. Eagle on Eminent Domain for Urban Revitalization Five Years After Kelo

By Professor Steven J. Eagle

August 24, 2010

SUMMARY: Get the latest Emerging Issues Analysis on *Kelo v. City of New London*, the landmark U.S. Supreme Court decision holding that condemnation of non-blighted homes for retransfer for private urban redevelopment did not violate the Fifth Amendment's Public Use Clause. This article examines cases since the *Kelo* decision and concludes that the Supreme Court's promise to prevent abuse of condemnation for private redevelopment largely has been unfulfilled.

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ARTICLE: Summary of Supreme Court Public Use Cases Through *Kelo*

The Public Use Clause of the Fifth Amendment states that "...nor shall private property be taken for public use, without just compensation." Since the nineteenth century, the U.S. Supreme Court has decided three important cases interpreting "public use." In *Berman v. Parker*, 348 U.S. 26, 75 S. Ct. 98, 99 L. Ed. 27 (1954), Justice William O. Douglas wrote for a unanimous Court that the federal government could condemn a sound department store building in connection with redevelopment of the blighted District of Columbia neighborhood surrounding it. If the government had adopted a legitimate end, slum eradication, it could choose the means, including eminent domain.

Likewise, in *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 104 S. Ct. 2321, 81 L. Ed. 2d 186 (1984), the Court upheld the condemnation of underlying fee interests for re-transfer to homeowners holding long-term ground leases. Justice Sandra Day O'Connor justified the taking as serving the public uses of breaking up dramatically concentrated land ownership and ending inflated land prices. She stated that "[t]he 'public use' requirement is ...coterminous with the scope of a sovereign's police powers" [467 U.S. at 240]. Her reference was not intended to obviate the need for just compensation when eminent domain was exercised, but rather to suggest that there was no need for independent Public Use Clause analysis where the government's action could have been justified under the police power.

Finally, in *Kelo v. City of New London*, 545 U.S. 469, 125 S. Ct. 2655, 162 L. Ed. 2d 439 (2005), the Supreme Court held that the condemnation of non-blighted homes for retransfer for private urban redevelopment did not violate

the Public Use Clause. Justice John Paul Stevens, writing for the 5-4 majority, stressed that Connecticut had declared New London a distressed city, that there was an exhaustive comprehensive plan that would use the condemned neighborhood as a catalyst for revitalization and relief of unemployment, and that the private redeveloper had not been selected when the plan was approved.

In a strong dissent, Justice O'Connor averred that the Court's earlier public use cases were based either on actual use by the public or on the alleviation of harm, and "public use" based on neither left condemnation essentially unconstrained. "The specter of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory" [545 U.S. at 503].

In response, Justice Stevens emphasized that States could adopt stricter limitations on eminent domain and that *Kelo* would not justify condemnation of the property of one person for the benefit of another. Cases of abuse "can be confronted if and when they arise" [545 U.S. at 486-487]. Similarly, a concurring opinion by Justice Kennedy, warned that courts would protect against condemnation primarily for private benefit: "There may be private transfers in which the risk of undetected impermissible favoritism of private parties is so acute that a presumption (rebuttable or otherwise) of invalidity is warranted under the Public Use Clause" [545 U.S. at 493].

State Law Developments After Kelo

In the five years since *Kelo* was decided, legislation to limit or forbid condemnation for retransfer for private revitalization has been introduced in most states and passed in many. This legislation has been a mixed bag, with some states simply adding procedural hurdles or purporting to eliminate such takings, and others providing exceptions for loosely defined "blight." Generally speaking, anti-*Kelo* legislation has been mostly utilized in States where revitalization condemnation has not been utilized and least successful where it has been most utilized. For a comprehensive analysis, see Steven J. Eagle & Lauren A. Perotti, "Coping with *Kelo*: A Potpourri of Legislative and Judicial Responses," 43 *Real Property, Probate and Trust J.* 799 (2008).

Likewise, some state courts have stringently restricted or forbidden takings for retransfer for private revitalization under state law. Notable among them are *County of Wayne v. Hathcock*, 471 Mich. 445, 684 N.W.2d 765 (Mich. 2004), decided the year before *Kelo*, that repudiated the state supreme court's earlier approval of revitalization transfers, and *City of Norwood v. Horney*, 110 Ohio St. 3d 353, 853 N.E.2d 1115 (Ohio 2006), where the Supreme Court of Ohio held that "an economic or financial benefit alone is insufficient to satisfy the public-use requirement" of the state constitution [853 N.E.2d at 1142]. The court accepted the analyses offered by the dissenting justices in *Kelo* and in *County of Wayne v. Hathcock* as models for interpreting Ohio's constitution.

Cases Responding to Abuse Claims Predicated on Kelo Assurances

While States always have been free to limit problematic exercises of eminent domain, this analysis focuses on the interpretation by federal and state courts of the assurances against abusive condemnation provided by *Kelo*.

Deference to Legislative and Administrative "Public Use" Determinations

Normally, courts apply a rational basis test to economic and social legislation and regulation, including condemnation. This implies deference to local land use regulation and to whether a given exercise of eminent domain is intended primarily to benefit the public. On the other hand, Justice Stevens assured in *Kelo* that courts would confront cases of abuse, "if and when they arise" [545 U.S. at 487]. However, meaningful confrontation would imply that aggrieved condemnees could obtain the specifics necessary to buttress their claims through discovery, and that courts would evaluate those claims using a reasonable standard.

Perhaps the leading cases illustrating the tensions among these principles arose from the massive Atlantic Yards redevelopment project in Brooklyn, N.Y. It involved condemnation of the neighborhood around a former railroad yard for residential towers, including luxury housing, a basketball stadium, and other amenities.

In the New York Court of Appeals case, *Goldstein v. New York State Urban Development Corp.*, 2009 NY Slip Op 8677, 13 N.Y.3d 511, 921 N.E.2d 164 (N.Y. 2009), the plaintiffs had alleged there was no blight, despite reliance on a study to the contrary paid for by the developer, and that the project's public purpose was incidental and subordinate to private gain. With respect to blight, the court stated:

It may be that the bar has now been set too low -- that what will now pass as "blight," . . . should not be permitted to constitute a predicate for the invasion of property rights and the razing of homes and businesses. But any such limitation upon the sovereign power of eminent domain as it has come to be defined in the urban renewal context is a matter for the Legislature, not the courts. . . . [A] reweighing of public as against private interests and a reassessment of the need for and public utility of what may now be outmoded approaches to the revivification of the urban landscape . . . are not tasks courts are suited to perform. They are appropriately situated in the policy-making branches of government. 921 N.E.2d at 172-173.

The issue of pretextual takings was central to the related Second Circuit case, *Goldstein v. Pataki*, 516 F.3d 50 (2d Cir. 2008). The court summarized:

The heart of the complaint, however, and the centerpiece of the instant appeal, is its far-reaching allegation that the Project, from its very inception, has not been driven by legitimate concern for the public benefit on the part of the relevant government officials. Appellants contend that a "substantial" motivation of the various state and local government officials who approved or acquiesced in the approval of the Project has been to benefit Bruce Ratner, the man whose company first proposed it and who serves as the Project's primary developer. Ratner is also the principal owner of the New Jersey Nets. In short, the plaintiffs argue that all of the "public uses" the defendants have advanced for the Project are pretexts for a private taking that violates the *Fifth Amendment*. 516 F.3d at 54.

The Second Circuit noted that various features of the project, such as blight elimination, building a new sports arena, creating new housing, and creating affordable housing, were "well-established public uses," and that these aspects were missing in previous cases in which courts found pretextual takings.

In contrast, the particular kind of "pretext" claim the plaintiffs in this case advance bears an especially dubious jurisprudential pedigree: The plaintiffs have effectively acknowledged the Project's rational relationship to numerous well-established public uses, but contend that it is constitutionally impermissible nonetheless because one or more of the government officials who approved it was actually-and improperly-motivated by a desire to confer a private benefit on Mr. Ratner. The allegations in support of this claim primarily involve purported excesses in the costs of the plan as measured against its benefits. The appellants seek to use these alleged failings to gain discovery into the process by which the ESDC approved this Project. Among other things, as was made clear at oral argument, they seek depositions of pertinent government officials, along with their emails, confidential communications, and other pre-decisional documents. They also dispute various plausible assumptions underlying the Project's budget.

Allowing such a claim to go forward, founded only on mere suspicion, would add an unprecedented level of intrusion into the process. See *Kelo*, 545 U.S. at 488. . . .

Accordingly, we must reject the notion that, in a single sentence, the *Kelo* majority sought *sub silentio* to overrule *Berman*, *Midkiff*, and over a century of precedent and to require federal courts in all cases to give close scrutiny to the mechanics of a taking rationally related to a classic public use as a means to gauge the purity of the motives of the various government officials who approved it. 516 F.3d at 62.

Most recently, the New York Court of Appeals reversed an intermediate appellate court's holding that, *Goldstein* notwithstanding, takings in the Morningside Heights neighborhood of Manhattan were not for the benefit of the public, but rather for the benefit of Columbia University, which had wholly underwritten the project. In *Kaur v. New York State Urban Development Corp.*, 2009 NY Slip Op 8976, 72 A.D.3d 1, 892 N.Y.S.2d 8 (App. Div. 2009), the intermediate court declared: "the blight designation in the instant case is mere sophistry. It was utilized by ESDC years after the

scheme was hatched to justify the employment of eminent domain but this project has always primarily concerned a massive capital project for Columbia. Indeed, it is nothing more than economic redevelopment wearing a different face" [892 N.Y.S.2d at 16]. The Court of Appeals reversed, declaring that "given our precedent, the de novo review of the record undertaken by the plurality of the Appellate Division was improper" [2010 N.Y. LEXIS 1181 at 23], and that assistance to private as well as public universities constituted public uses [2010 N.Y. LEXIS 1181 at 29].

These holdings suggest that judicial deference to local land use and condemnation determinations will create a threshold test, rather than a test implicating proportionality. Once some non-trivial amount of public benefit is conferred, courts may not second-guess the balance of public and private benefit that is conferred.

However, this standard is contrary to that suggested by Justice Kennedy in his *Kelo* concurrence:

The determination that a rational-basis standard of review is appropriate does not, however, alter the fact that transfers intended to confer benefits on particular, favored private entities, and with only incidental or pretextual public benefits, are forbidden by the Public Use Clause.

A court applying rational-basis review under the Public Use Clause should strike down a taking that, by a clear showing, is intended to favor a particular private party, with only incidental or pretextual public benefits, just as a court applying rational-basis review under the Equal Protection Clause must strike down a government classification that is clearly intended to injure a particular class of private parties, with only incidental or pretextual public justifications. 545 U.S. at 490-491.

Along similar lines, judicial deference to local condemnation apparently led the New Jersey Supreme Court to subordinate its mandate that localities have an affirmative duty to provide affordable housing, established in 1975. *Southern Burlington County NAACP v. Township of Mount Laurel*, 336 A.2d 713 (N.J. 1975), 456 A.2d 390 (N.J. 1983). In 2005, however, when a landowner protested that Mount Laurel's condemnation of its land for open space was a pretext to prevent residential development, an intermediate appellate court ruled noted that "case [was] governed by the general rule that '[c]ourts will generally not inquire into a public body's motive concerning the necessity of the taking or the amount of property to be appropriated for public use'" [*Mount Laurel Township v. Mipro Homes, LLC*, 878 A.2d 38, 50 (N.J. Super. Ct. App. Div. 2005) (citations omitted)]. It concluded that the town had not abused its eminent domain power, "even if the primary goal of Mount Laurel's open space acquisition program in general, and the condemnation of the Mipro site in particular, is to slow down residential development in the municipality" [878 A.2d at 49]. The court cited *Kelo* for the proposition that "the same public purposes that justify the use of public funds to acquire land for open space by voluntary acquisition also justify invocation of the power of eminent domain" [878 A.2d at 48]. The New Jersey Supreme Court affirmed in a *per curiam* opinion stressing evidence of New Jersey voters' desire to provide for open space funding [910 A.2d 617 (N.J. 2006)].

Considering Types of Private Transfers Susceptible to Abuse

In addition to his comments on rational basis review just quoted, Justice Kennedy declared in his concurring opinion in *Kelo* that general adherence to rational basis review "does not foreclose the possibility that a more stringent standard of review than that announced in *Berman* and *Midkiff* might be appropriate for a more narrowly drawn category of takings. There may be private transfers in which the risk of undetected impermissible favoritism of private parties is so acute that a presumption (rebuttable or otherwise) of invalidity is warranted under the Public Use Clause" [545 U.S. at 493].

One situation that might lend itself to heightened judicial scrutiny is the imposition of exactions by government-selected redevelopers in exchange for promises not to condemn. This was the issue in *Diden v. Village of Port Chester*, 322 F. Supp. 2d 385 (S.D.N.Y. 2004), adjudicating claims of extortionate exactions by a developer threatening condemnation under color of law.

After a public hearing and its determination of public use, the Village designated a redevelopment area and gave its

selected redeveloper power to condemn parcels within the district. The plaintiffs alleged that the developer demanded \$800,000 from them in order to avert a condemnation proceeding against their property. Further, the developer offered to allow plaintiffs to proceed with a pharmacy project on the land, but only if defendants were given a partnership interest in the project. When plaintiffs refused both demands, the village condemned their property pursuant to the developer's designation. The federal district court dismissed the plaintiffs' complaint.

On appeal, the Second Circuit held that plaintiffs' claims were time-barred, since the appellants knew the basis of their injury when the redevelopment district was delineated. "[E]ven if Appellants' claims were not time-barred, to the extent that they assert that the Takings Clause prevents the State from condemning their property for a private use within a redevelopment district . . . *Kelo* . . . obliges us to conclude that they have articulated no basis upon which relief can be granted." The developer's demands were neither an unconstitutional exaction in the form of extortion nor an equal protection violation [*Didden v. Village of Port Chester*, 173 Fed. Appx. 931, 933 (2d Cir. 2006), cert. denied, 549 U.S. 1166 (2007)].

Didden illustrates a particularly troubling aspect of permitting a redeveloper to select parcels to be condemned for retransfer for private redevelopment. Outright condemnation deprives the owner of the affected parcel of the difference between his or her subjective value and the fair market value for which just compensation must be paid. The number of owners thus adversely affected cannot exceed the number of parcels actually taken. *Didden*, however, permits redevelopers to seek monetary payments in exchange for excluding parcels from the condemnation scheme. Thus, it appears to pave the way for the exaction by redevelopers of much of the subjective value in many parcels, thus creating a vastly increased potential for mischief. For this reason alone, it seems unwise for the Second Circuit panel (which included now-Justice Sonia Sotomayor) to have treated the case as a routine application of *Kelo*.

Guidance for Counsel Litigating Public Use Clause Issues

Among other questions that counsel will want to consider in analyzing public use cases in light of early judicial responses to *Kelo* are the following.

- Timely assertion of claims. As *Didden* indicates, many states will regard the passage of legislation or the promulgation of notice of administrative determinations as commencing the time in which landowners can challenge findings of blight, public benefit, and the delineation of special districts. Since owners might not know or care about such rulings until adverse actions are taken with respect to their land, it often seems inefficient to acquire knowledge or mount administrative or judicial challenges. Nevertheless, that such vigilance is the better course often is established in retrospect. Neighborhood or trade associations might assume the cost and burden of asserting property owner rights.
- Documentation of prejudicial actions is essential. As the Second Circuit's *Goldstein v. Pataki* opinion illustrates, it is difficult to obtain discovery in cases where there is a suspicion of local government and developer collusion leading to pretextual condemnation. Therefore, landowners and their counsel should endeavor to attend meetings, document who is permitted to speak and what is said, and otherwise gather affidavits and other evidence of possible irregular conduct. While obviously not conclusive, evidence that decisions were taken before the studies ostensibly leading to them were made is helpful.
- Vigorously assert all viable claims, including substantive due process. Condemnation involving a disputable public use, in the same manner as other exercises of eminent domain, could be challenged on such grounds as inadequate compensation, severance damages to adjoining property not condemned, and "condemnation blight," by which the condemnor has acted to reduce the pre-condemnation value of the property. Also, procedural challenges might be predicated on such factors as lack of proper notice of the designation of a redevelopment district.

Justice Kennedy was the necessary fifth vote in *Kelo*. His concurring opinion asserted notions of fairness and proportionality that have great appeal. Many federal and state courts have yet to test the extent to which a taking loses its public character because benefit to the public is small in proportion to private benefit, and the extent to which developer participation in the selection of redevelopment projects makes condemnation for those projects constitutionally suspect. These might be the basis of substantive due process challenges based on lack of "pubic use" for condemned parcels.

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5 of 79 DOCUMENTS

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Tartaglia on Establishing Standing under SEQRA in Land Use Cases

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Establishing Standing under SEQRA in Land Use Cases

By Alfred Tartaglia Esq.

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SUMMARY: Alfred C. Tartaglia, Esq. provides analysis on the New York Court of Appeals' decision in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*. The analysis focuses on the "injury in fact" and "special harm" requirements which must be satisfied to establish standing under the SEQRA and the manner in which those requirements apply to groups challenging land use determinations.

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ARTICLE: Overview: *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany* addresses the standing of environmental groups to challenge land use determinations under SEQRA. The Court specifically adhered to the "special harm" standing requirement earlier enunciated by the Court in *Society of Plastics Industry, Inc. v. County of Suffolk*, 77 N.Y.2d 761, 570 N.Y.S.2d 778, 573 N.E.2d 1034 (1991), which mandates that a party challenging agency action under SEQRA establish direct harm or injury which is in some way different from that of the public at large. The Court rejected the concept of "citizen standing" which would permit an environmental group to contest actions which injure the environment without having to demonstrate special harm. The decision was nevertheless "a clear victory" for environmental groups. See Gerrard, *Court of Appeals Expands SEQRA Standing After an 18-Year Detour*, *supra*, N.Y.L.J., November 27, 2009, at 3, col. 1. The Court adopted an expansive definition of the concept of "injury which is in some way different from the public," holding that an individual who establishes that he or she enjoys a public natural resource, such as a park, more than most other members of the public is injured in a manner different from the public generally - the standard applied by the Appellate Division majority and urged by the New York State Department of Environmental Conservation, as amicus curiae. In so defining "special harm," the Court took an approach at odds with a growing view in the lower courts, which had held that, by definition, an injury to a public resource is an injury to the public itself, and thus not an injury specific to any individual person.

Examining standing, special damages, injury in fact and *Society of Plastics Industry, Inc. v. County of Suffolk*: In *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, the Court of Appeals reexamined the standing requirements which must be satisfied for a party to challenge, in court, a land use determination under SEQRA, and in particular, the proper application of those standing requirements to environmental groups. The key to understanding the significance of *Matter of Save the Pine Bush, Inc. v. Common Council of the City*

of Albany is understanding the requirements of "injury in fact" and "special damages" as prerequisites for standing under SEQRA - requirements first established by the Court of Appeals in 1991 in *Society of Plastics Industry, Inc. v. County of Suffolk*, *supra*. To fully understand *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, then, it is necessary to review *Society of Plastics*.

In *Society of Plastics*, a manufacturer of plastic products sought to nullify a law enacted in Suffolk County which barred retail food establishments from serving food in non-biodegradable polystyrene or polyvinyl chloride packaging. Plaintiff, a plastics manufacturer residing in Suffolk County, challenged the law under SEQRA on the ground that the Suffolk County Legislature as lead agency had failed to prepare an EIS. The issue presented was whether the individual plastics manufacturer had standing.

The Court began its analysis with an observation that the New York State Legislature, in enacting SEQRA, had failed to set forth any guidance for determining standing. Nevertheless, borrowing principles of law developed outside of the context of SEQRA, the Court ruled in *Society of Plastics* that in order to establish standing, a party must demonstrate an injury in fact (i.e., "an actual legal stake in the matter being adjudicated") which falls within the zone of interests sought to be promoted or protected by SEQRA - i.e., the environmental as opposed to economic effects of proposed agency actions. (*Id.* at 772-773.) In short, to establish standing under SEQRA, a party must show, initially, that it will be impacted by the environmental effects of a proposed agency action.

It will not suffice, however, for a party to establish merely that the party will be affected by the environmental effects of a proposed agency action. There must also be proof that the individual will be directly and personally aggrieved by these environmental effects. The Court noted that in land use cases in particular, whether predicated on SEQRA or on other grounds, the injury must constitute "direct harm, injury that is in some way different from that of the public at large." (*Id.* at 774.) The requirement of "direct harm" or "special harm" made applicable to SEQRA cases by *Society of Plastics* is excused only when the party seeking standing resides in close proximity to the property which is the subject of the proposed action. See *Sun-Brite Car Wash, Inc. v. Board of Zoning & Appeals*, 69 N.Y.2d 406, 515 N.Y.S.2d 418, 508 N.E.2d 130 (1987) (a property owner in close proximity to the property for which a use variance was granted had standing to seek judicial review without pleading and proving special damages, because the adverse effect or aggrievement in a way different from the community at large could be *inferred* from proximity to the affected property); *Michalak v. Zoning Bd. Of Appeals of Town of Pomfret*, 286 A.D.2d 906, 731 N.Y.S.2d 129 (4th Dept. 2001) (party seeking standing must reside within 500 feet of a challenged project).

Applying these principles in *Society of Plastics*, the Court held that the plaintiff manufacturer could not rely on any alleged economic harm resulting from the county law to assert standing, as economic injury is not within the zone of interests sought to be protected by SEQRA. As to environmental harm, the Court reasoned that any alleged harmful environmental consequences of the county law barring plastics would manifest themselves in an increased volume of solid waste, which would impact those residing near landfills. Accordingly, residents near landfills would have standing. Plaintiff, not showing that it was located near a landfill, did not have standing.

Observing the requirements of organizational standing: In *Society of Plastics*, the court noted that the same principles of standing apply whether the party seeking relief is an individual or an association. If an association or organization is seeking relief, a tripartite test applies: (1) one or more of its members must individually have standing to sue ("standing cannot be achieved merely by multiplying the persons a group purports to represent"); (2) the association must demonstrate that the interests it asserts are germane to its purposes so as to satisfy the court that it is an appropriate representative of those interests; and (3) it must be evident that neither the asserted claim nor the appropriate relief requires the participation of the individual members. Because at least one individual member of an organization must have standing to sue, SEQRA cases involving environmental groups have tended to focus on the standing, or lack of standing, of the individual member or members of the organization.

Standing after *Society of Plastics*; no "citizen standing" or "public action" lawsuits: *Society of Plastics* has been perceived by many, and environmental groups in particular, as overly restrictive in "barring the courthouse doors"

to SEQRA challenges. See, e.g., Weinberg, *Are Standing Requirements Becoming A Great Barrier Reef Against Environmental Actions?*, 1999 N.Y.U. Env. Law Jour., Vol. 7, at 25; Matthews, *Unlocking the Courthouse Doors*, 65 *Alb. Law Rev.* 421. Environmental groups have understandably sought to achieve standing based on their perceived role as protectors of the public interest or "private attorney generals," and thus they have argued that a showing of direct injury should not be required. The argument that the rule of *Society of Plastics* should be abrogated in favor of citizen-standing or public advocacy standing was in fact made by Save Pine Bush, Inc., in its brief as respondent before the Court of Appeals in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, where the argument was again rejected (see the discussion, *infra*).

Standing as applied to environmental groups prior to *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*: In SEQRA land use cases decided after *Society of Plastics*, to establish standing, the plaintiffs or petitioners were required to demonstrate either one or both of the following:

- (1) That an individual plaintiff or petitioner lived within close proximity (i.e., 500 feet or less) to the property which was the subject of rezoning, proposed construction, or other proposed action; or,
- (2) That the individual plaintiff or petitioner would suffer an environmental injury which was in some manner different from that which would be suffered by the public generally.

Since frequently no individual associated with an environmental group resided near the property which was being developed, the environmental group was required to establish standing under (2) above. In numerous cases it was held that an environmental group's allegations of environmental harm were not sufficient to establish standing because the environmental harm was suffered by the public generally, and thus the injury alleged by the environmental group was no different in kind or degree than that suffered by the public generally.

In *Society of Plastics*, the Court made the following observation with respect to the standing of environmental organizations:

"Factually, this case presents a variation from the more common scenario of associations dedicated to environmental preservation seeking to represent the interests of persons threatened with environmental harm (see, e.g., *Save a Valuable Env't. v City of Bothell*, 89 Wash 2d 862, 576 P2d 401; *Sierra Club v Morton*, 405 U.S. 727). In such instances, in-fact injury within the zone of interest of environmental statutes has been established by proof that agency action will directly harm association members in their use and enjoyment of the affected natural resources (see, e.g., *United States v Students Challenging Regulatory Agency Procedures*, 412 U.S. 669, 687). Here, by contrast, the parties seeking relief under SEQRA are a nationwide association of plastics interests and for-profit member corporations in the business of making and selling plastics products, entities whose economic interests are not served by bans on plastics products." *Society of Plastics Indus. v. County of Suffolk*, 77 N.Y.2d at 775 -- 776 (1991).

The Court of Appeals specifically cited *Sierra Club v Morton* (405 US 727, 734, 92 S.Ct. 1361, 31 L.Ed.2d 636 [1972]), in which an environmental group contested a planned ski resort on land known as Mineral King in the Sequoia National Forest, adjacent to the Sequoia National Park, which would have required the construction of a highway and the erection of transmission lines through the Sequoia National Park. The plaintiff environmental group had taken the position that it had the right to bring an action as a representative of the public interest. The United States Supreme Court rejected the theory of a "public action," and held, to the contrary, that the plaintiff was required to plead and prove injury in fact:

"The impact of the proposed changes in the environment of Mineral King will not fall indiscriminately upon every citizen. The alleged injury will be felt directly only by those who use Mineral King and Sequoia National Park, and for whom the aesthetic and recreational values of the area will be lessened by the highway and ski resort. The Sierra Club failed to allege that it or its members would be affected in any of their activities or pastimes by the Disney development. Nowhere in the pleadings or affidavits did the Club state that its members use Mineral King for any purpose, much less

that they use it in any way that would be significantly affected by the proposed actions of the respondents." (*Sierra Club v. Morton*, 405 U.S. 727, 735 [1972]).

Sierra Club v. Morton therefore stands for the proposition that injury to the environment qualifies as an injury in fact for standing purposes, but that the plaintiff must demonstrate that it would be injured by the proposed agency action by demonstrating that it uses the affected natural resource and that its usage would be adversely affected by the proposed action.

Standing cases in New York subsequent to *Society of Plastics* largely ignored the Court of Appeals' reference to *Sierra Club v. Morton*. Rather, where no individual plaintiff or petitioner lived within 500 feet of the property being developed, the cases focused on the requirement of "direct harm" which is "in some way different from that of the public at large." Typical of these cases is *Long Island Pine Barrens Soc'y v. Planning Bd.*, 213 A.D.2d 484, 623 N.Y.S.2d 613 (2d Dept. 1995), in which the lead agency issued a negative declaration for a 121-unit residential real estate project in a designated Special Groundwater Protection Area. The Appellate Division found that the petitioner environmental group's "generalized allegations" that the project would have a deleterious impact upon the aquifer lying beneath the South Setauket Pine Barrens were insufficient to establish standing, as the allegations did not demonstrate that the individual petitioners would suffer an environmental injury which was any way "different in kind and degree from the community generally."

The methodology employed in *Society of Plastics Industry, Inc. v. County of Suffolk* was specifically reaffirmed in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*: The particular dispute in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany* concerned an application to rezone a specific parcel of real property, used as a parking lot, from residential to commercial use, to permit the construction of a hotel. The property was privately owned, and not itself environmentally sensitive. The site was in fact surrounded on three sides by shopping malls, commercial office buildings and a major commercial corridor. On the fourth side, however, separated by a power line right-of-way, was located Butterfly Hill. As indicated in the Appellate Divisions' decision, Butterfly Hill, a habitat for the rare Karner Blue butterfly, was itself located 1000 meters east of the Pine Bush Preserve, an environmentally sensitive area of land measuring several thousand acres in Albany County set aside for the protection of the Karner Blue butterfly and other species. 56 AD3d at 34. The petitioner Save the Pine Bush, Inc., an environmental group dedicated to preserving the rare Karner Blue butterfly and its environs, had alleged, among other things, that the development of the private property at issue would affect the migration of Karner Blue butterflies from *Butterfly Hill to the Pine Bush Preserve*. 56 AD3d at 37. On these facts, the Appellate Division majority had held that the petitioners had standing. The Court of Appeals agreed. Initially, the Court rejected any argument that the principles of *Society of Plastics* be abandoned or "reformed" as urged by the petitioners in their brief to the Court of Appeals. The Court also rejected the notion that "residence close to a challenged project is an indispensable element of standing in every environmental case." 2009 N.Y. LEXIS 3998 at **9. Rather, the Court held that petitioner environmental group's use of a natural resource "more than most other members of the public" (id. at **1) satisfied the special injury requirement of *Society of Plastics*:

"Here, petitioners allege that they 'use the Pine Bush for recreation and to study and enjoy the unique habitat found there.' It is clear in context that they allege repeated, not rare or isolated use. This meets the *Society of Plastics* test by showing that the threatened harm of which petitioners complain will affect them differently from 'the public at large.' *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, 2009 NY Slip Op 7667, 4 (2009).

The Court characterized this rule as "similar to one long established in the federal courts," citing *Sierra Club v. Morton*, as it had done in *Society of Plastics*.

The concurring opinion by Judge Pigott, in which Judge Read joined, would have denied standing to petitioners on the ground that, among other things, petitioners failed to allege any direct injury that was different in kind or degree from that of the general public. In essence, because the Pine Bush and all of its natural resources can be used and enjoyed by the public at large, petitioners' potential loss of use and enjoyment of the Pine Bush's habitat amounted, in

the concurring judge's view, to the same general concerns of the community as a whole. Potential injury to the Pine Bush was not specific to the petitioners, the concurring judges reasoned, and thus could not constitute a legally cognizable injury for standing purposes.

The immediate result of the *Save the Pine Bush* litigation: The petitioners' victory on the issue of standing proved to be Pyrrhic, as the Court of Appeals had little trouble in denying the SEQRA challenge on the merits. By the time the case reached the Court of Appeals, all causes of action alleging a failure to adequately consider the effect of the proposed hotel on the Karner Blue butterfly had been dismissed, which the petitioners did not contest. This left only causes of action challenging a failure to assess the impact on other species. Applying "common sense," the Court reasoned that a lead agency may validly choose not to investigate matters of doubtful relevance under SEQRA. The City had properly focused on the potential environmental impact which the proposed hotel would have on the Karner Blue butterfly. The fact that little or no investigation was undertaken as to the environmental effects on certain other species was held to be rational, as no party involved in the SEQRA process had objected or commented on the failure to examine the impact on these species in the DEIS, and there was no evidence to believe that the project would threaten those species.

The effect of *Save the Pine Bush*; proving that an injury is real, and different from that of the general public: The Court in *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany* recognized that in future a factual challenge could well be raised to the environmental group's claims that it uses a resource in a manner or degree different from that of the public generally. In particular, whether a particular individual has standing may be challenged factually based on the frequency of the alleged use of the natural resource and the nature of that use. The burden of proof is on the plaintiff or petitioner. As the Court observed:

"In recognizing that petitioners' alleged injuries are a sufficient basis for standing, we do not suggest that standing in environmental cases is automatic, or can be met by perfunctory allegations of harm. Plaintiffs must not only allege, but if the issue is disputed must prove, that their injury is real and different from the injury most members of the public face. Standing requirements 'are not mere pleading requirements but rather an indispensable part of the plaintiff's case' and therefore 'each element must be supported in the same way as any other matter on which the plaintiff bears the burden of proof' (*Lujan*, 504 U.S. at 561). Here, the City does not challenge the reality of the injuries petitioners assert -- understandably so, since it seems highly likely that many members of an organization called Save the Pine Bush, Inc. are people who frequently visit and enjoy the Pine Bush. But in other cases, including those brought by organizations devoted to less specific environmental interests -- the plaintiff in *Sierra Club*, for example -- plaintiffs may be put to their proof on the issue of injury, and if they cannot prove injury their cases will fail." *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany*, 2009 NY Slip Op 7667, 5 (2009).

Future cases may well focus on the manner and degree of proof required by an individual member of a group bringing a SEQRA challenge to establish that he or she in fact "frequently" and "repeatedly" uses a natural resource more than most other members of the public.

The effect of *Save the Pine Bush*; distinguishing various factual scenarios: It should be noted that challenges by environmental groups may be viewed as falling into four broad categories - i.e., (1) those cases in which a proposed action concerning the use of public property would potentially adversely affect that public resources (e.g., *Sierra Club v. Morton*, in which a ski resort was proposed on environmentally sensitive public land); (2) those cases in which a proposed action affecting private property would potentially adversely affect nearby public resources (e.g., *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany*, in which a proposed hotel would have potentially affected nearby Butterfly Hill and the Pine Bush); (3) those cases in which a proposed project or action on private property would potentially adversely affect the habitat of the private property itself (e.g., *Matter of Save Pine Bush, Inc. v. Planning Bd. of Town of Clifton Park*, 50 A.D.3d 1296, *infra*, in which development of privately-owned, unimproved land would arguably have destroyed a habitat of the Karner Blue butterfly located on the property to be developed); and (4) those cases in which a proposed action on public or private property would potentially adversely affect the environment, generally. The effect of *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany* in

each of these categories or types of cases remains to be seen.

In the first category, where a proposed action affecting public property would potentially adversely affect public resources, an individual using the public resource repeatedly and regularly, and thus more than most other members of the public, would presumably have standing under *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany*. These cases may likely result in factual challenges as to the nature and frequency of the use of the public resource.

Under the second category of cases, in which a proposed action involving private property would potentially adversely affect nearby public resources, again, factual disputes as to the nature and frequency of the use of the public resource may arise. In addition, it is not now clear that all concepts of spatial proximity must be abandoned. To be sure, the affected individuals need not live in proximity to the subject property; none of the petitioners in *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany* claimed to live in close proximity to the proposed hotel. But does *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany* indicate that an environmental group such as the petitioner, which is able to establish the requisite use of a protected natural resource, may challenge a project, no matter where the project is located, even if the potential impact on the public resource is negligible? In this regard, the concurring judges warned that the majority opinion in *Matter of Save the Pine Bush, Inc. v Common Council of the City of Albany* would do just that, giving the petitioners standing under SEQRA based on agency action concerning project sites located far from any natural resource:

"Here, the project site is not within the Pine Bush preserve, but rather is private property located in a heavy commercial corridor. Unlike the Pine Bush preserve, the project site is not used by petitioners -- or the general public -- for any purpose and it possesses no recreational value. The harm asserted by petitioners is a general harm that the project site may have on a completely different, recreational site, the Pine Bush preserve. The majority's holding, taken to its logical conclusion, results in Save the Pine Bush and its members having standing to sue whenever a project site, no matter where its location, may have a potential impact on animals and plants that happen to live on the Pine Bush." *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, concurring opinion, 13 NY3d at 311. (Emphasis added).

It remains to be seen if *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany* will be as broadly construed as the concurring judges cautioned. It must be noted that the proposed hotel in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany* was located "near" Butterfly Hill, which in turn was located less than a mile from the Pine Bush Preserve. It does not appear that any party contested as being unrealistic the underlying assumption that the distance from the proposed hotel to Butterfly Hill or the Pine Bush Preserve was close enough that the development of the affected property could potentially affect those protected sites. Would standing have been found if the proposed hotel was located ten miles from either Butterfly Hill or the Pine Bush Preserve? What if Butterfly Hill and the Pine Bush Preserve were located a hundred miles distant from the proposed hotel? Would the Court have required proof demonstrating that the environmental impacts on Butterfly Hill or the Pine Bush Preserve were (at least potentially) "real?" Would standing require some showing, by expert evidence or otherwise, of a rational basis for the assertion that the proposed development would affect a natural resource located vast distances from the project site?

With respect to the third category of cases, consider a proposed development on private property which will potentially affect or destroy an animal habitat located on the property itself. Will individuals not residing in proximity to the private property, and not seeking to protect a public resource located near the private property, be able to establish standing? In *Matter of Save Pine Bush, Inc. v. Planning Bd. of Town of Clifton Park*, 50 A.D.3d 1296, 856 N.Y.S.2d 687 (3d Dept. 2008), leave denied, 10 N.Y.3d 716, 892 N.E.2d 403, 862 N.Y.S.2d 337 (2008), a property owner submitted a site plan to the Planning Board of the Town of Clifton Park seeking to construct seven light industrial buildings on undeveloped land. A portion of this property had been identified as a potential habitat for the Karner Blue Butterfly; butterflies had allegedly previously been seen on the property. The Planning Board, as lead agency for the project, issued a negative declaration and granted site plan approval. In finding that petitioner Save the Pine Bush, Inc. and its

individual members did not have standing to commence a CPLR article 78 proceeding challenging this determination, the Appellate Division held that the petitioners' interest in observing butterflies on private property by stationing themselves on the public road was not a "use" different than that enjoyed by the public at large. The Third Department, in its decision in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*, distinguished *Matter of Save the Pine Bush, Inc. v. Planning Bd. of Town of Clifton Park* in part by stating "[a] significant distinction in the two cases is the fact that the petitioners in *Clifton Park* had no protected interest in the use and enjoyment of viewing Karner Blue Butterflies on private property...." (56 AD3d at 38.) It is not now clear whether or to what extent observing natural resources from the public roadway, even if done regularly, repeatedly, and for a long duration, constitutes a usage different from that of the public at large.

The fourth category of cases set forth above includes those cases in which everyone is equally harmed by the agency action, and thus no particular person has standing. An example may be a case involving air pollution, in which the pollution does not manifest its effects in a manner that is more pronounced in any particular geographic area. See Gerrard, *Court of Appeals Expands SEQRA Standing After an 18-Year Detour*, *supra*, N.Y.L.J., November 27, 2009, at 3, col. 1. The Court of Appeals clearly did not view the facts in *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany* as presenting a situation in which only "general harm" would result from the proposed action, and the case does not address that scenario. How that situation will be addressed was left open in *Society of Plastics* (77 N.Y.2d at 788), and remains an open question under *Matter of Save the Pine Bush, Inc. v. Common Council of the City of Albany*.

In short, as with all important cases, the full extent of the decision must await further clarification from the Court in varying factual contexts.

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Mr. Tartaglia was the author of numerous chapters for various treatises before he was invited to become a General Editor for Matthew Bender and Company (now a division of LexisNexis) in 1999. In that capacity he has updated two treatises on real property law and practice-Warren's *Weed New York Real Property* and Steinman's *Bergerman and Roth, New York Real Property Forms Annotated*.

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Mr. Tartaglia is a graduate of Duke University, where he majored in English, and received his Juris Doctor from New York Law School in 1980. He was admitted New York State Bar in 1981, and the United States Supreme Court in 1999. He is a former Board Member and present chair of Continuing Legal Education Committee, Columbian Lawyers

Association, First Department, 2001.

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6 of 79 DOCUMENTS

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Michael Allan Wolf on Stop the Beach Renourishment, Inc. v. Florida DEP

2010 Emerging Issues 5148

Michael Allan Wolf on Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection, 2010 U.S. LEXIS 4971 (June 17, 2010)

By Michael Allan Wolf

June 29, 2010

SUMMARY: Michael Allan Wolf analyzes the U.S. Supreme Court's decision in *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection* and its importance to the future state protection of beaches and coastal real property. He explains why attorneys should now be prepared to launch and defend "judicial takings" and due process claims in the event that state high courts shift existing law to the detriment of property owners.

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ARTICLE: *All Eight Justices Upheld Florida Supreme Court's Rejection of Property Owners' "Judicial Takings" Claim*

On June 17, 2010, the eight participating U.S. Supreme Court Justicesⁿ¹ found that Florida's highest court, in rendering an opinion concerning the rights of beachfront property owners and the validity of a state statute on beach restoration, did not "take" the landowners' property without providing just compensation in violation of the Fifth Amendment's Takings Clause. The subject area of the litigation, state protection of beaches and coastal real property, is of great contemporary import, not only because of global concerns about rising seas, but also because of the current massive oil spill in the Gulf of Mexico that poses serious threats to coastal landowners and communities. The good news for state courts (and for state and local governments and their attorneys) is that the Supreme Court, paying careful attention to longstanding, common-law principles such as accretion, reliction, and avulsion,ⁿ² has upheld an ambitious state legislative scheme, the Beach and Shore Preservation Act,ⁿ³ that was designed to restore and renourish Florida beaches while respecting the rights of private property owners. **The good news for private property rights advocates and their clients is that four members of the High Court have expressed their willingness to entertain lawsuits based on a "judicial takings" theory.** The other four justices, however, found that the plurality's discussion of the idea that a state court could effect a violation of the Fifth Amendment's Takings Clause was either unwise or unnecessary and premature.

In the Unanimous Part of its Opinion, the U.S. Supreme Court Affirmed the State High Court's Rejection of a Takings Claim, Based on Traditional Principles of Florida Law of Accretion and Avulsion

The petitioner, Stop the Beach Renourishment (STBR), whose members own beachfront property in the Florida Panhandle (on the Gulf of Mexico), challenged the state Department of Environmental Protection (DEP) for granting permits to local governments in order "to restore 6.9 miles of beach within their jurisdictions that had been eroded by several hurricanes." n4 The restoration project involved the addition of 75 feet of sand to what was then submerged land. Florida law has long established state ownership in trust of "the land permanently submerged beneath navigable waters and the foreshore (the land between the low-tide line and the mean high-water line)." n5 This means that "the mean high[8209]water line (the average reach of high tide over the preceding 19 years) is the ordinary boundary between private beachfront, or littoral property, and state[8209]owned land." n6 With the addition of the new sand, the state would designate the mean high-water line as the "erosion-control line," which would constitute the boundary between public and private land. The district court of appeal sided with STBR, finding that a regulatory taking n7 had occurred in that DEP "had eliminated two of the [STBR] Members' littoral rights: (1) the right to receive accretions to their property; and (2) the right to have the contact of their property with the water remain intact." n8 The Supreme Court of Florida then addressed the following certified question: " 'On its face, does the Beach and Shore Preservation Act unconstitutionally deprive upland owners of littoral rights without just compensation?' " n9

The state high court answered the question in the negative and reversed the district court of appeal that had failed to "consider[] the doctrine of avulsion, which [the supreme court] concluded permitted the State to reclaim the restored beach on behalf of the public." n10 Moreover, the supreme court "described the right to accretions as a future contingent interest, not a vested property right, and held that there is no littoral right to contact with the water independent of the littoral right of access, which the Act does not infringe." n11 The U.S. Supreme Court granted certiorari and affirmed, relying heavily on the Florida justices' interpretation and application of their own state statutory and decisional law.

In a unanimous part of the Court's opinion, written by Justice Antonin Scalia, the justices reviewed key principles of traditional property law regarding the ownership interests of littoral and riparian owners. First the Court distinguished accretion and reliction (gradual change) on the one hand from avulsion (sudden change) on the other:

Accretions are additions of alluvion (sand, sediment, or other deposits) to waterfront land; relictions are lands once covered by water that become dry when the water recedes. (For simplicity's sake, we shall refer to accretions and relictions collectively as accretions, and the process whereby they occur as accretion.) In order for an addition to dry land to qualify as an accretion, it must have occurred gradually and imperceptibly—that is, so slowly that one could not see the change occurring, though over time the difference became apparent. When, on the other hand, there is a "sudden or perceptible loss of or addition to land by the action of the water or a sudden change in the bed of a lake or the course of a stream," the change is called an avulsion. n12

Justice Scalia then explained the reason why the distinction makes a real difference:

In Florida, as at common law, the littoral owner automatically takes title to dry land added to his property by accretion; but formerly submerged land that has become dry land by avulsion continues to belong to the owner of the seabed (usually the State). Thus, regardless of whether an avulsive event exposes land previously submerged or submerges land previously exposed, the boundary between littoral property and sovereign land does not change; it remains (ordinarily) what was the mean high[8209]water line before the event. It follows from this that, when a new strip of land has been added to the shore by avulsion, the littoral owner has no right to subsequent accretions. Those accretions no longer add to *his* property, since the property abutting the water belongs not to him but to the State. n13

The unanimous Court also placed the burden upon STBR to "show that, before the Florida Supreme Court's decision, littoral[8209]property owners had rights to future accretions and contact with the water superior to the State's right to fill in its submerged land." n14 In the absence of superior private rights, there would be no private property for the state supreme court to "take" under any takings theory. Justice Scalia explained that established Florida law "allowed the State to fill in its own seabed, and the resulting sudden exposure of previously submerged land was treated like an avulsion for purposes of ownership." n15 **The fact that existing state law made no distinction between**

natural and state-created avulsion (as in the case before the Court) proved fatal to STBR's private property rights claims.

The Court also rejected STBR's contention that the State had taken "the Members' littoral right to have their property continually maintain contact with the water." n16 Contrary to STBR's argument, which was based on the petitioner's reading of dictum in an earlier Florida decision, n17 once the erosion-control line was set, this purported right was subsumed under the landowners' continuing right of access to the water.

Four Justices Opened the Door to "Judicial Takings" Claims

While Justice Scalia spoke for a unanimous Court in affirming the state supreme decision and in finding that the "decision did not contravene the established property rights of [STBR's] members," n18 the Court was deeply divided over the question of whether a court decision could ever effect a Fifth Amendment "judicial taking." Four members of the Court—Justices Scalia, Samuel Alito, Clarence Thomas, and Chief Justice John Roberts—went on record as supporting the following idea: "If a legislature or a court declares that what was once an established right of private property no longer exists, it has taken property, no less than if the State had physically appropriated it or destroyed its value by regulation." n19 This recognition that private property can, in the words of the Fifth Amendment, "be taken" not only by eminent domain, by destruction, and by regulation, *but also by judicial decision*, potentially provides a new litigation strategy for property owners who believe that a state court has, by changing existing law, violated their constitutionally protected private property rights.

Justice Scalia took several paragraphs of the plurality part of his opinion to address, sometimes in a biting tone, the objections of his four more hesitant colleagues. Justice Anthony Kennedy, joined by Justice Sonia Sotomayor, opined that "[t]he Court would be on strong footing in ruling that a judicial decision that eliminates or substantially changes established property rights, which are a legitimate expectation of the owner, is 'arbitrary or irrational' under the Due Process Clause." n20 Justice Stephen Breyer, joined by Justice Ruth Bader Ginsburg, wrote that "the plurality unnecessarily addresses questions of constitutional law that are better left for another day." Unpersuaded by the arguments that (1) substantive due process provided a better alternative for protecting private property rights from state court shifts (Kennedy opinion) and (2) it was not necessary for the Court to address the takings question at all (Breyer opinion), the plurality established two important key guideposts for future litigants interested in pushing the takings envelope.

First, Justice Scalia and his three colleagues sought to establish the notion "that the existence of a taking does not depend upon the branch of government that effects it." n21 In other words, courts can "take" private property the same way that a local or state legislature, Congress, or federal, state, or local regulators can. This means, for example, that, contrary to DEP's argument, there is no special requirement that, in order to find a judicial taking, the federal court must conclude that there was no "fair and substantial basis" for the challenged state court decision. n22

Second, the plurality rejected petitioner STBR's proposed "unpredictability test," deriving from Justice Potter Stewart's concurring opinion in *Hughes v. Washington*: n23 "Whether the decision here worked an unpredictable change in state law thus inevitably presents a federal question for the determination of this Court." n24 Justice Scalia explained that the key consideration in a judicial takings case "is not whether there is precedent for the allegedly confiscatory decision, but whether the property right allegedly taken was established." n25 In other words, a shift in judge-made property rules that was not unexpected could result in a judicial taking of an established property right if the private right were eliminated by the shift. n26 Likewise, an unpredictable change or clarification in property law does not necessarily result in a judicial taking, particularly if private property rights are not eliminated. There must be a shift in the law, and there must be a confiscation or taking of an established private property right occasioned by the shift.

Will 4 + 2 = Victory for Landowners?

Counsel for landowners and other private property owners who believe that courts have confiscated their Fifth

Amendment rights by adopting new positions regarding principles of property law can be expected to do simple mathematics before drafting their complaints. Taking up the invitation of the four justices in the plurality, we can expect to see a spate of complaints in which landowners will assert a judicial takings theory under the Fifth Amendment Takings Clause (as applied to the states by means of incorporation). We can also expect to continue to see as a second constitutional theory, based on the views of Justices Kennedy and Sotomayor, claims that courts have allegedly confiscated established property rights in violation of the Due Process Clause of the Fourteenth Amendment by issuing judicial decisions that are "arbitrary or irrational." ⁿ²⁷ In this way, four justices plus two justices might add up to an effective strategy for a narrow class of landowners who, unlike the plaintiffs in *Stop the Beach Renourishment*, can demonstrate that their established property rights were confiscated by members of the judicial branch.

How Will *Stop the Beach* Change the Legal Landscape

Technically, the U.S. Supreme Court, like their colleagues on the Supreme Court of Florida, did not change property law. However, as a practical matter, because the plurality's strong dictum appears to be a strong invitation for a future case that "fits," attorneys representing landowners and state and local governments should be prepared to launch and defend "judicial takings" claims whenever a state high renders a decision that arguably confiscates "an established right of private property."

Practitioners should keep these factors in mind:

- **Judicial Takings Theory Might Apply in a Broad Range of Property and Property-Related Situations.**

The judicial changes that would trigger a takings claim could conceivably occur not only in "typical" real property cases involving doctrines of real estate, land use planning, and environmental law, but in any area of the law in which private property *rights* are threatened. This would include cases involving personal and intellectual property *at a minimum*.

- **Existing Regulatory Takings Tests Apply.** The plurality opinion explained that judicial takings are not "entitled to special treatment." ⁿ²⁸ Therefore, the tests that the Court has developed for regulatory takings would be applicable in this new context as well.

- **Unpredictability Is Not an Essential Element.** While a sudden shift in the law is more likely to give rise to a claim that the court has confiscated established property rights, the plurality asserted that a judicial takings claim could be based even on a change in judge-made law that was predictable or that could be anticipated based on prior cases.

- **Consider Due Process Claims.** Now that Justice Sotomayor has joined Justice Kennedy in demonstrating a willingness to entertain substantive due process challenges to allegedly confiscatory or arbitrary judicial decisions regarding property law, if the facts are favorable attorneys representing landowners should seriously consider a claim based on the Due Process Clause as a middle course between two "extremes" (the plurality's judicial takings approach and the traditional deference accorded government regulators of property).

[Return to Text](#)

ⁿ¹ Justice John Paul Stevens, a landowner on Florida's coast, recused himself.

ⁿ² See Chapter 66 of this Powell on Real Property (Michael Allan Wolf ed., LexisNexis Matthew Bender) for a full discussion of these traditional property and water law concepts.

n3 Fla. Stat. §§ 161.011-.45.

n4 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *15-*16.

n5 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *9.

n6 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *9-*10 (footnote omitted).

n7 See §§ 79.03[2], 79E.03, and 79F.05[4] of Powell on Real Property (Michael Allan Wolf ed., LexisNexis Matthew Bender) for discussion of regulatory takings doctrine and precedents.

n8 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *16-*17 (citing *Save Our Beaches, Inc. v. Florida Dept. of Environmental Protection*, 27 So. 3d 48, 57 (2006)).

n9 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *17 (quoting *Walton County v. Stop the Beach Renourishment, Inc.*, 998 So. 2d 1102, 1105 (2008)).

n10 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *18.

n11 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *18.

n12 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *11-*12 (citations omitted) (quoting *Board of Trustees of Internal Improvement Trust Fund v. Sand Key Assoc., Ltd.*, 512 So. 2d 934, 936 (Fla. 1987)).

n13 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *12-*13 (citations omitted).

n14 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *48.

n15 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *50.

n16 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *53.

n17 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *54 (citations omitted) (quoting *Board of Trustees of Internal Improvement Trust Fund v. Sand Key Assoc., Ltd.*, 512 So. 2d 934, 936 (Fla. 1987)).

n18 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *54.

n19 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *23-*24 (plurality).

n20 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *60 (Kennedy, J., concurring in part and concurring in the judgment). For a discussion of substantive due process in property cases, see §§ 70.05, 79E.04, and 79F.06 of *Powell on Real Property* (Michael Allan Wolf ed., LexisNexis Matthew Bender).

n21 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *40 (plurality).

n22 *See Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *40-*41 (plurality).

n23 *Hughes v. Washington*, 389 U.S. 290 (1967).

n24 *Hughes v. Washington*, 389 U.S. 290, 297 (1967) (Stewart, J., concurring).

n25 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *45-*46 (plurality).

n26 Here is the example provided by Justice Scalia:

If, for example, a state court held in one case, to which the complaining property owner was not a party, that it had the power to limit the acreage of privately owned real estate to 100 acres, and then, in a second case, applied that principle to declare the complainant's 101st acre to be public property, the State would have taken an acre from the complainant even though the decision was predictable.

Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection, 2010 U.S. LEXIS 4971, at *46 (plurality).

n27 *See Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *60 (Kennedy, J., concurring in part and concurring in the judgment) ("The Court would be on strong footing in ruling that a judicial decision that eliminates or substantially changes established property rights, which are a legitimate expectation of the owner, is 'arbitrary or irrational' under the Due Process Clause.").

n28 *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection*, 2010 U.S. LEXIS 4971, at *21 (plurality).

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7 of 79 DOCUMENTS

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Robert M. Jaworski on RESPA

2010 Emerging Issues 5014

Robert M. Jaworski on RESPA: Spring Is in the Air -- An Assessment of the New Year's Day 2010 GFE/HUD-1 Rules Changes

By Robert Jaworski

May 5, 2010

SUMMARY: In this expert's look at the important RESPA changes implementing the new GFE and HUD-1/1A effective January 1, 2010, Robert M. Jaworski provides a recap of the new rules, identifies important implementation issues, and discusses the challenges involved in providing much-needed clarity.

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ARTICLE: While mortgage lenders and mortgage brokers ("Loan Originators"), as well as borrowers, have been grappling with the new GFE/HUD-1 rule (the "New Rule") now for more than a year and a quarter - adhering to the New Rule has been mandatory. n1 So it's probably a good time to assess how things have been going in terms of implementation. To set the stage, a quick recap of the New rules is in order.

The New GFE.

The new GFE consists of three pages. The first page is the most critical, with HUD envisioning consumers using it to comparison shop for a mortgage loan. On it, the Loan Originator will disclose estimated loan costs ("Your Adjusted Origination Charges," "Your Charges for All Other Settlement Services" and the "Total Estimated Settlement Charges") and loan terms (initial loan amount, term, initial interest rate, initial monthly payment amount, whether the interest rate can increase, and whether the loan allows for negative amortization or provides for a prepayment penalty or a balloon payment).

To provide the consumer with an opportunity to shop for a better deal, these costs and terms (except for the interest rate and any costs and terms that are dependent upon the interest rate), must remain "fixed," *i.e.*, within prescribed tolerances, for at least 10 business days, absent "changed circumstances." The initial interest rate is also fixed, but only for the period stated on the GFE-which can be less than 10 days-unless the consumer locks in that rate. If the consumer accepts this "offer," the terms and costs must then remain fixed through the closing, again within the same prescribed tolerances and absent "changed circumstances."

The second page of the new GFE details the origination charges and the other settlement service charges and groups them into categories, including "Our origination charge," "Required services that we select," "Title services and lender's title insurance," and "Required services that you can shop for." The origination charge is adjusted to reflect (i) as a credit, any yield spread premium ("YSP") that the lender will pay to a mortgage broker (if one is involved), or (ii) as a charge, any discount points the borrower pays to lower the interest rate.

The last page of the GFE gives general information to consumers as to how best to use the form, and an optional "tradeoff table" on which the Loan Originator may set forth two loan options—one that describes a loan for which the consumer would pay a higher interest rate but less in settlement charges, and another that describes a loan for which the consumer would pay a lower interest rate but more in settlement charges. Finally, it includes a blank table where consumers may insert and compare relevant data concerning other loan offers that they receive.

GFE Timing. The new GFE must be provided within three business days following receipt of a consumer's "application," which is defined as the applicant's submission to the Loan Originator of financial information in anticipation of a credit decision, including, *at minimum*, name, monthly income, social security number, property address, estimate of the value of the property, and the desired loan amount, plus whatever other information, other than *verifying* information or documentation, the Loan Originator deems necessary. Loan Originators may only charge the customer a credit report fee to obtain the GFE.

Fee and Rate Tolerances. The New Rule restricts changes in fees and loan terms disclosed on the GFE and the actual fees and terms disclosed on the HUD-1, and refers to those limitations as "tolerances."

The tolerance for all lender and mortgage broker origination fees, transfer fees, and, if the interest rate has been locked, any discount points or YSPs, is zero, meaning that none of these items may exceed by any amount the number disclosed on the GFE.

The tolerance for the *total* of (1) all lender-required settlement services paid to providers selected by the lender, (2) all lender-required settlement services paid to providers selected by the borrower from lender-provided lists, (3) premiums for optional owners' title insurance selected by the borrower from lender-provided lists, and (4) government recording fees is 10%.

All other charges disclosed on the GFE are permitted to change by any amount, so long as the estimate was offered in "good faith."

Changed Circumstances. Within three business days after learning that "changed circumstances" exist, the Loan Originator may deny the loan or issue a new GFE showing different terms and/or costs. "Changed circumstances" are: (1) Acts of God, war, disaster, or other emergencies; (2) application information that the lender relied on in providing the GFE but which subsequently changes or is found to be inaccurate; (3) information on the borrower's credit report obtained before providing the GFE that subsequently changes; (4) new information particular to the borrower or the transaction (other than the items of financial information that at minimum constitute an "application") not relied on by the lender in providing the GFE; and (5) other circumstances particular to the borrower or the transaction, such as boundary disputes, need for flood insurance, and environmental problems.

Post Settlement Cure. The New Rule permits Loan Originators to cure a tolerance violation within 30 calendar days after settlement by reimbursing to the borrower the excess amount.

The New HUD-1/1A.

The New Rule also changes the form of HUD-1/1A Settlement Statement to more easily permit comparisons with the new GFE. The new HUD-1 form is three pages long and the HUD-1A is two pages. The first page of the HUD-1 is unchanged. The second page of the HUD-1 and the first page of the HUD-1A are changed to include (1) fee terminology consistent with that used on the new GFE, specifically, "Our origination charge," "Your credit or charge for

the specific interest rate chosen," "Your adjusted origination charge," "Title services and lender's title insurance," and "Required services that you can shop for"; (2) references to the line number on the GFE at which the same charge appears; and (3) a breakdown of the portion of the total title insurance premium that goes to the title underwriter and the title agent.

The final page of both forms is new. It includes comparison charts of the loan terms and attendant costs disclosed on the GFE (or, if a revised GFE has been issued based on changed circumstances, the most recent such GFE) with the actual terms and costs of the loan being closed, and shows the borrower whether the tolerance limits on fees have been exceeded. This page, at the bottom, also directs borrowers with questions to "please contact your lender."

Implementation Issues.

As expected, numerous implementation issues have arisen as a result of the New Rule. HUD has attempted to provide guidance to the industry with respect to many of these issues by publishing on its website a series of answers to "frequently asked questions" ("FAQs"). See http://www.hud.gov/offices/hsg/ramh/res/respa_hm.cfm. As of May 2, 2010, the most recent version of these FAQs, now 62 pages long, is dated April 2, 2010.

Most of the FAQs address questions regarding the new GFE. Among these questions are:

- How to fill in the blanks on page 1 in the "Important Dates" section related to rate locks if you do not offer rate locks?
- How to fill in the blanks on page 1 in the "Summary of your loan" section with respect to loans with nontraditional features (*e.g.*, interest-only loans, bi-weekly payment loans, loans with conditional preferred rate features)?
- How to disclose originator charges on page 2 in connection with loans for which the borrower will pay "discount points" and the lender will pay a "yield spread premium?"
- How to disclose "title services and lender's title insurance" when the borrower is permitted to shop for some but not all of those title services?
- Whether transfer taxes need be disclosed where state law and/or custom obligates the seller to pay those taxes?
- How many providers must be included on the list of providers supplied by the Loan Originator with regard to services for which borrower may shop?
- What specific circumstances will qualify as "changed circumstances?"
- What constitutes "origination services" that will be included in Block 1?
- What is a "no cost" loan and how must it be disclosed?
- May Loan Originators provide pre-approvals without having to give a GFE?
- Are lenders bound by GFEs provided by a mortgage broker?

The New HUD-1/1A has also drawn its share of questions, such as the following:

- How should a tolerance violation "cure" be disclosed on the HUD-1/1A.
- How should borrower charges that are paid by the Loan Originator, the seller or a third party be reflected on the HUD-1/1A?
- When a mortgage broker closes a loan in its own name using funds supplied by a table-funding lender, in whose name must the HUD-1/1A be completed?
- If state law so requires, may fees be itemized that the New Rule requires be aggregated?
- How to differentiate on the HUD-1/1A deductible origination points from other origination charges?

Observations.

Over the past year or so, my partners and I have been barraged with questions from clients preparing to use the new forms. Based on these questions and the practical concerns which precipitated them, I offer the following

observations.

First, while a bit late out of the starting gate, HUD has done a noteworthy job helping to provide urgently needed guidance to the industry. Nevertheless, the New Rule is still a work in progress, with many questions still left unanswered, and many more still unasked - questions such as

- whether the old mortgage broker business model remains viable in the new RESPA disclosure regime,
 - whether originators may collect some but not all of the items of information required to constitute an "application" and, on that basis, either prequalify or preapprove borrowers without having to give a GFE until later in the process
- programs will assume a more important role in the mortgage origination process,
- whether consumers' experiences with the new forms will engender praise or criticism,
 - what will the Federal Reserve Board ("FRB") do now that the New Rule has taken effect, and
 - how does a Loan Originator document changed circumstances and the impact those circumstances have on specific loan terms and/or cost estimates?

Second, while each expansion of the HUD FAQs provides needed clarity to Loan Originators, it has also added another layer of complexity to disclosure forms the primary purposes of which are to help consumers shop for a mortgage loan and to simplify the process.

Third, some of the HUD FAQs have unfortunately not been sufficiently precise to admit of only one interpretation and, for that reason, interpretations vary where uniformity should prevail. Much to its credit, HUD has in fact revisited some FAQs in order to clarify their meaning.

Fourth, some of the HUD FAQs appear to go beyond the plain meaning of the pertinent provisions of the New Rule and, in some instances, may even be inconsistent with those provisions. Recognizing that RESPA and Regulation X insulate persons from liability only for acts done or omitted in good faith in conformity with a HUD regulation or official interpretation (published in the Federal Register), it will be interesting to see how much leeway regulators and courts will give to Loan Originators who adhere to those FAQs.

Finally, HUD's stated goal of improving consumers' understanding of the settlement process and their ability to shop for a mortgage loan still seems far away. Based on anecdotal evidence, the new forms appear to have made consumers more rather than less confused and to have not altered their mortgage loan shopping practices as intended. That said, it seems premature to conclude that consumers will continue to be confused.

Outlook. Where do we go from here? Some have expressed the view that the primary problem with the New Rule is that it was adopted with little or no input from or coordination with the FRB, which most importantly has rulemaking authority over the Regulation Z disclosures. This problem underscores the desirability of a single regulator having rulemaking authority over all mortgage loan related consumer disclosures. A simple, consolidated disclosure should be the goal, and that goal appears too difficult to attain with multiple regulators involved, each with its own agenda and constituencies.

Regulatory reform efforts now being debated and discussed may have an impact here, particularly if the proposed (and highly controversial) Consumer Financial Protection Agency becomes a reality. Barring that, the ball appears to be in the FRB's court. And Loan Originators and consumers will need to continue to grapple with the New Rule as best they can.

[Return to Text](#)

n1 The New Rule was adopted in November, 2008. *73 Fed. Reg. 68204* (November 17, 2008). It became effective January 1, 2010.

RELATED LINKS: See

- http://www.hud.gov/offices/hsg/ramh/res/respa_hm.cfm

For additional coverage of RESPA, see discussion by Robert M. Jaworski, Esq. in

- Powell on Real Property Ch. 37A, The Impact of the Truth in Lending Act and RESPA Upon Real Estate Financing, (Michael Allan Wolf ed., LexisNexis Matthew Bender).

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Mr. Jaworski thanks his partner, Leonard A. Bernstein, for his valuable contributions to this article.

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8 of 79 DOCUMENTS

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REAL ESTATE LOAN WORK OUTS AND RESTRUCTURINGS

2010 Emerging Issues 5004

REAL ESTATE LOAN WORK OUTS AND RESTRUCTURINGS FOR TENANT IN COMMON OWNERS

By Mr. Edward J. Hannon

May 4, 2010

SUMMARY: Get the latest on real estate transactions structured as "Tenant In Common transactions." This article provides an overview of the "TIC Structure," gives guidance on dealing with the TIC Structure for underperforming property, examines the hurdles that can be created by the TIC loan documents, and provides the keys to a successful TIC restructuring.

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ARTICLE: REAL ESTATE LOAN WORK OUTS AND RESTRUCTURINGS FOR TENANT IN COMMON OWNERS

Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code"), sets forth specific rules for the deferral of gain on the sale of real estate in a "like kind exchange." In 2002, the Internal Revenue Service provided specific tax guidance on the use of a Tenant In Common ownership structure for use in tax-free like kind exchanges under Code Section 1031 [see *Rev. Proc. 2002-22*]. Subsequent to the issuance of this tax guidance, the number of real estate transactions structured as Tenant In Common transactions ("TIC Structure") expanded significantly.

If a property is owned by a single owner or through an entity with a principal decision maker, addressing the operational and lender issues that typically arise when property is underperforming can be straightforward. If the underperforming property is owned through a TIC Structure, however, addressing these issues can be problematic. In fact, the process can appear to be nearly insurmountable if the underperformance is caused by operational problems rather than by external issues.

Overview of the TIC Structure

In a typical TIC Structure, up to 35 unrelated investors may purchase ownership interests in income producing commercial real estate and take title as co-owners through separate single-member limited liability companies (each

limited liability company, a "TIC Owner"). At the same time that the investor purchases their undivided fractional ownership interest in the property (a "TIC Interest"), the investor, through the TIC Owner, also enters into various other agreements with affiliates of the company that sold the TIC Interest to the TIC Owner (the "TIC Sponsor"). For example, under the Asset Management TIC Structure, the TIC Owners enter into an asset management agreement with an affiliate of the TIC Sponsor. Under the Master Lease TIC Structure, the TIC Owner enters into a Master Lease with an affiliate of the TIC Sponsor. In both instances, the TIC Sponsor affiliate is typically a newly formed limited liability company.

Under the asset management agreement with the TIC Owners, the TIC Sponsor affiliated Asset Manager receives a monthly asset management fee that is typically a percentage of gross receipts. Thus, under the Asset Management TIC Structure, the TIC Owners' monthly return is based on the flow-through of cash from the property after payment of debt service, operating expenses, and funding of reserves. Under the Master Lease TIC Structure, the affiliate of the sponsor (the "Master Lessee") is obligated to pay expenses related to the operation of the property and an amount of Master Lease rent to the TIC Owners as specified in the Master Lease. Thus, unlike the Asset Management TIC Structure, in the Master Lease TIC Structure the TIC Owners' return would be based on the rent set forth in the Master Lease rather than flow-through of cash after payment of debt service, operating expenses, and funding of reserves.

Dealing with the TIC Structure for an Underperforming Property

Underperformance can be caused by factors beyond the control of the TIC Sponsor or the TIC Owners. For instance, the bankruptcy of a significant tenant, over-development of similar properties near the property, or a general economic downturn in the geographic area around the property can cause a property to underperform. Over the last 24 months, there have been allegations by TIC Owners that properties' underperformance was caused by a lack of attentiveness by the Asset Manager because of internal cost cutting necessitated by the TIC Sponsor's inability to bring new TIC deals to be marketed. If a property is underperforming, the TIC Sponsor will seek to raise funds through a capital call from the TIC Owners. If the TIC Owners perceive that the TIC Sponsor is not being sufficiently attentive to the situation or if the TIC Owners cannot obtain a clear understanding of the financial condition of the property from the information supplied by the TIC Sponsor, raising funds through a capital call might be difficult. In these circumstances, many TIC Owners will feel the need to examine whether another party should be brought in to replace the TIC Sponsor. Pursuing this course of action, however, raises many issues that will need to be resolved for the TIC Owners to successfully replace the existing TIC Sponsor with another Asset Manager or Master Lessee.

Obtaining Information Can Be Difficult

In many TIC Investments, the investors who acquire the TIC Interests are unrelated to one another and their sole point of contact is through the TIC Sponsor. In some cases, the investors will only know the identity of the other owners by reference to the name of the special purposes entity that was formed in connection with each owner's acquisition of the TIC Interest (i.e., the TIC Owner).

To take action independent of the TIC Sponsor, the investors must first organize themselves and establish a way to communicate with one another. The next task is to gather objective financial information about the property and its operations. This can generally include contact information for tenants and information regarding the status of various leasing activities.

In the case of an underperforming property, the difficult tasks of establishing lines of communication among the TIC Owners and of obtaining relevant information about the property is typically done in the context of a pending loan default. The TIC Owners need to conduct fact-finding (e.g., identifying all investors) in order to be in a position to address the corrective action that is needed to avoid default and foreclosure.

Additional Hurdles Can Be Created by the TIC Documents and the Loan Documents

Once the TIC Owners have organized themselves and gathered information about the property, the next issue that

is typically raised (in the case of an underperforming property) is determining who is available to replace the TIC Sponsor as the Asset Manager or Master Lessee. Even where a potential replacement candidate can be quickly identified, completing this process will require the TIC Owners to overcome several hurdles that are imbedded in the TIC Structure.

In a typical TIC Structure, the TIC Owners enter into a Tenant In Common agreement and, in some cases, a separate call agreement (collectively, the "TIC Documents"). The provisions of the TIC Documents are designed to address the tax requirements of *Revenue Procedure 2002-22*. As a result, the decision making provisions of the TIC Documents are somewhat cumbersome. For example, to comply with the requirements of *Revenue Procedure 2002-22*, many TIC Documents provided that the decision to amend the Master Lease or to enter into a new or amended asset management agreement required the unanimous consent of the TIC Owners. This unanimous consent requirement can be problematic in instances in which the principals of the TIC Sponsor own TIC Interests in the troubled property and in instances in which not all of the TIC Owners can be found.

Even when unanimous consent can be obtained, provisions contained in the loan agreements (for property owned through a TIC Structure) can make it difficult to remove a non-performing TIC Sponsor. In many cases, the acquisition of the real estate for a TIC Investment, in both the Asset Management TIC Structure and the Master Lease TIC Structure, was funded through a CMBS loan, which has become part of a pool of securitized loans. In a typical TIC Investment, the owners of the TIC Interest are not liable under the loan beyond their investment in the underlying real estate (e.g., non recourse). However, in a typical TIC Investment, both the investors (individually) and the principals of the TIC Sponsor have exposure to springing recourse liability under the so-called "nonrecourse carve outs."

One typical nonrecourse carve out is the termination of the Master Lease or Asset Management without the advance written consent of the lender. Thus, even if the TIC Owners can obtain unanimous consent to terminate the existing agreement with the affiliates of the TIC Sponsor, they cannot terminate the existing asset management agreement or Master Lease unless they can also obtain the written consent of the lender to do so.

Issues Related to Lender Communications

As a practical matter, obtaining lender consent can be a difficult task. In many cases, the loan documents will typically designate the Master Tenant or Asset Manager as the sole person who is authorized to contact the lender. As a result, the lender will not communicate with anyone (other than the TIC Sponsor) without written authorization from the TIC Sponsor.

The inability to communicate with the lender creates significant problems for the TIC Owners if the property is underperforming and default under the loan is imminent. Accordingly, TIC Owners must be prepared to take the appropriate actions to open these lines of communication, either by negotiating with the TIC Sponsor to obtain its cooperation or through other avenues.

Bankruptcy Issues Can Also Exist in a TIC Property Workout

The use of the Master Lease TIC Structure raises additional issues in the context of a troubled TIC Sponsor. Under the Master Lease TIC Structure, the Master Lessee enters into leases with the tenants in its own name. The Master Lease also provides that all payments related to the property, other than debt service, will be paid by the Master Lessee. In many cases, contracts for the operation of the property were also held in the name of the Master Lessee rather than in the name of the TIC Owners. (In contrast, under the Asset Management TIC Structure, the Asset Manager typically enters into leases with the tenants on behalf of the TIC Owners. In addition, in the typical asset management structure, contracts related to the operation of the property are entered into by the asset management in the name of the TIC Owners.)

If the TIC Sponsor is facing financial difficulty and a transfer from the existing TIC Sponsor to a new Asset Manager or Master Lessee cannot be achieved, additional complications arise under the Master Lease TIC Structure if

the TIC Sponsor seeks (or is forced into) bankruptcy protection. In fact, these complications were clearly illustrated in a recent bankruptcy case involving a large TIC Sponsor in November 2008.

In this case, a TIC Sponsor adopted the Master Lease TIC Structure, and the TIC Sponsor then caused each of the Master Lessee entities to file for bankruptcy. As a result of this bankruptcy filing, all of the cash generated by the properties was held by the bankruptcy estate under the supervision of the Bankruptcy Court, rather than distributed to the TIC Owners pursuant to the Master Lease terms. Also, because the tenant leases were in the name of the Master Lessee and not the TIC Owners, some risk existed that the termination of the Master Lease through the bankruptcy, without a specific assignment of the underlying tenant leases, could give the tenant grounds to seek to renegotiate the terms of the assigned lease.

Keys to a Successful TIC Restructuring

As noted above, the tax-oriented requirements of the TIC Structure create significant hurdles to resolving the various issues that arise in connection with an underperforming property. Additional hurdles are created if the TIC Sponsor's actions contributed to the property's underperformance. To place the TIC Owners in a position to take corrective action and save their investment in the property, each of the issues identified above must be addressed. Each situation involving a troubled TIC property is unique because of the specific circumstances of the property itself, such as the sophistication of the TIC Owners and the TIC Sponsor. As a result, there is no "cookie cutter" approach that can be adopted to resolving these issues.

In many situations involving distressed properties owned through a TIC Structure, repositioning the property will require the recapitalization of the property. The tax-oriented restrictions of the TIC Structure can make this recapitalization difficult if less than all of the TIC Owners are willing to contribute their pro rata share of the additional funds. Accordingly, in a workout situation, the TIC Owners may be required to examine whether they need to adopt an alternative structure to facilitate the workout. In some distressed property situations caused by the actions of the TIC Sponsor, the conversion of the TIC Structure to a multi-member limited liability company or contribution of the property to an UPREIT may be viable options for such a structure.

The Future of TIC Property Workouts

The TIC Structure was not designed with a distressed property structure in mind. Knowing where these structural shortcomings arise, however, can help TIC Owners take the steps necessary to turn the property from an underperforming property into a performing property. In many cases, the TIC Sponsor will undertake specific actions to provide as much transparency as possible to the TIC Owners on the operation of the property. A limited number of TIC Sponsors who have experienced loss of revenue from the inability to sell TIC Interests, have cut back their operations to the point where they can no longer properly manage their existing TIC properties. In these circumstances, TIC Owners must move quickly to overcome the hurdles identified above if they want to take the steps that may be necessary to pursue a workout with the lender.

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9 of 79 DOCUMENTS

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NEW FORECLOSURE STATUTE

2010 Emerging Issues 4911

NEW FORECLOSURE STATUTE -- LAWMAKERS HAMMER MORTGAGE LENDERS

By Bruce Bergman

March 17, 2010

SUMMARY: New York State has passed foreclosure statutes which will impose considerable delay upon the mortgage foreclosure process and create numerous new opportunities for borrowers and other defendants to contest the foreclosure case. The law will also expose lenders to potentially significant repair and maintenance costs for properties during foreclosure as well as other costs.

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ARTICLE: There is ample historic evidence that lenders have not been an exalted group. But of course they serve a critical role in society and need to be able to enforce their rights when, for example, a mortgage may go into default. That ability and the efficiency attendant to it can readily be compromised, however, by state statutes. That some under-appreciation of lenders continues may be implied by a host of new foreclosure laws in many jurisdictions.

New York State as a prime example has passed foreclosure statutes which will impose considerable delay upon the mortgage foreclosure process and create numerous new opportunities for borrowers and other defendants to contest the foreclosure case. (See RPAPL §§ 1303, 1304, 1305, 1306, 1307 and CPLR §3408) The law will expose lenders to potentially significant repair and maintenance costs for properties during foreclosure - and even after foreclosure - as well as incurrence of increased insurance premiums, legal and administrative costs and exposure to tort liability. It will also work a reversal of title priorities so that leases junior to the mortgage will survive foreclosure and thereby be elevated to seniority.

Here, just as a short introduction, is a list of the new requirements in outline form:

- Notice to all tenants concerning their rights to remain at the mortgaged premises must be mailed within ten days of service of the summons and complaint (even if tenants are not being served). (RPAPL §1303 effective 30 days after December 15, 2009.)
- Ninety-day notice of default to be sent to borrowers for all home loans, including co-ops, (no longer confined to sub-prime or any amount) as a condition precedent to foreclosure. (RPAPL § 1304 effective 30 days after December 15,

2009.)

- Post-sale notice to be given to all tenants or occupants allowing those with a lease (even oral or implied) to remain for the balance of the lease (others to remain for 90 days after notice.) (RPAPL §1305 effective 30 days after December 15, 2009.)
- Within three business days after mailing the pre-foreclosure ninety-day notice, the lender must file certain information about the mortgage loan with the Superintendent of Banks and then plead compliance with this requirement in any foreclosure complaint. (RPAPL §1306 effective 60 days after December 15, 2009.)
- Lender to be responsible to maintain property in foreclosure action after "obtaining" judgment of foreclosure and sale until recording of referee's deed out of a sale. This obligation applies if property is vacant, becomes vacant after judgment, or is tenant-occupied but abandoned by the mortgagor. (RPAPL § 1307 effective 120 days after December 15, 2009.)
- Mandatory conferences for all home loans (one-to-four family owner- occupied) within sixty days of filing proof of service with the court, negotiations to be in good faith. (CPLR §3408 effective 60 days after December 15, 2009.)

In their zeal to please borrower and tenant constituencies, lawmakers may be losing sight of some critical realities. Time is an enemy of the foreclosure process and *all* its parties. The passage of *some* time can be salutary; it allows the defaulting borrower to pursue a rescue path, be that sale or refinancing of the property, the filing of a bankruptcy or arranging some settlement with the lender. But foreclosures are already overly extended, in some judicial foreclosure states (like New York), often measured in years. So it is not as if there is a paucity of time available needing yet more time to be imposed upon in the process.

The danger of all the delay inevitable with the new requirements is that time translates into accrual of debt through ever accumulating interest. Administrative costs, litigation fees, taxes and insurance (and in the instance of a junior mortgage, possible advances to the senior lender) also mount.

The greater the debt - ever increasing by the noted factors - the more onerous it becomes to settle the case. More must be paid by the borrower or the lender must sustain a still greater loss, or both. None of this can be an agreeable consequence.

Then too, should a foreclosure action proceed to sale, the foreclosing lender is entitled to receive only the sum adjudicated as due to it. So if the foreclosure sale brings a sum greater than due the lender, the overage - the surplus - is available to any other lienors on the property and, if sufficient, ultimately to the borrower. Except in times of wildly escalating real property values (certainly not these days) the passage of time, the delay in the foreclosure action, will assure that the debt escalates to extinguish any possible surplus.

The converse is also a factor. If the debt becomes greater than the value of the property, it creates a deficiency for which the borrower (and possibly others, i.e., friends or family who were guarantors) is personally liable. Thus, time and expense lead to dual undesirable events - surpluses disappear and deficiencies arise.

So what do new statutes demand? One is a lengthy pre-foreclosure notice (in New York, ninety-days) as a condition of starting a foreclosure. (Of course this grafts an additional three months on the process.) This gives no credence to the existing requirement in most residential mortgages nationally (via the Fannie Mae/Freddie Mac uniform instrument) that a thirty-day default (i.e. cure) notice must be sent. Nor does it credit the efforts of lenders' existing loss mitigation departments, devoted to avoiding or ameliorating foreclosures because, in part, lenders abhor non-performing loans.

Then there are requirements for mandatory court settlement conferences which add still more months of delay. Mindful that borrowers who could never have afforded the mortgages in the first instance (the case of the liar loan - no documentation) or the problem that a borrower with no job just cannot make the payments, it should not be surprising that most settlement attempts fail. Even for those cases where a mortgage modification results, the office of the Comptroller of the Currency reported that less than three in ten mortgages modified by servicers in the first quarter of

2008 were current as of August 2009. And Fitch Ratings in analyzing loss mitigation efforts for the first half of 2009 conservatively projects that 65% to 75% of securitized subprime loan modifications will fall back into default a year after modification. Even these figures understate the modifications which fail because they do not include remodified loans later liquidated.

That the time and expense suffered by a foreclosure action would result in a borrower losing a claim to surplus - because accrual of debt caused the excess to evaporate - or the borrower becoming personally liable for a significant deficiency, would doubtless be lamented by all. There is apparently far less sympathy for lenders which will incur ever greater losses as foreclosures are delayed, impeded and made more expensive through legal impositions. Banks and other lenders may apparently be faceless, but they are not strangers. They *are* us. We deposit our money in banks. We take car loans from banks (and would prefer competitive rates). The FDIC insures banks and funds that with fees from other banks. We own bank stocks, directly or in mutual funds. Public and private pension funds invest in banks. Securitized mortgages are owned by various funds in which individuals and pension funds invest. Fannie Mae and Freddie Mac own more than a trillion dollars in mortgages and we as taxpayers support those government sponsored enterprises now in conservatorship. TARP funds - our taxpayer monies - have been used to bail out banks. This is but a part of the equation and should make the point.

The enthusiasm of lawmakers to help citizens in apparent distress is understandable and laudable. Whether onerous foreclosure laws, however, will in the real world supply a hoped for result is more than doubtful. And in pursuing an elusive goal, the statutes pummel banks and other lenders - all of us in the end - creating ever greater losses.

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Widely recognized for his regular columns on mortgage foreclosure in both the *New York Law Journal* and the *New York Real Property Law Journal* and as a lecturer in his field for judge's groups, the New York State Bar Association, New York County Lawyers Association, the Nassau Academy of Law, Consumer Bankers Association, New York State Land Title Association, Professional Education Systems, Suffolk Academy of Law and the National Business Institute among many others, Mr. Bergman is both a past Director and four-term Chairman of the Real Property Law Committee of the Nassau County Bar Association as well as a former Associate Dean of the Nassau Academy of Law. Among his memberships are the American College of Real Estate Lawyers, American College of Mortgage Attorney, Scribes the American Society of Writers on Legal Subjects, the American and New York State Bar Associations, the New York Land Title Association and the American Arbitration Association for which he serves as an arbitrator. He was a City Councilman in Long Beach, New York, from 1980 through 1988.

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10 of 79 DOCUMENTS

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Impact of 2009 Revision of Maryland Rules of Procedure for Foreclosures

2010 Emerging Issues 4887

Jeffrey B. Fisher on Strategic Review of Maryland's New Rules of Practice and Procedure for Foreclosures of Interests in Real Property

By Jeffrey Fisher

February 26, 2010

SUMMARY: Effective May 1, 2009, the Maryland Court of Appeals adopted new rules of practice and procedure for foreclosures of interests in real property, repealing the former rules. The new rules contain many procedural changes and, even though the impetus for the changes came from legislation impacting foreclosures of residential property, the new rules are applicable to all foreclosures, and any foreclosure practitioner must become familiar with them.

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ARTICLE: On February 10, 2009, the Maryland Court of Appeals adopted a complete rewriting and renumbering of the rules governing foreclosures, effective May 1, 2009. The new rules remove inconsistencies between the prior rules and recent legislative enactments regarding foreclosure of residential properties, provide precise directions for compliance and proof of compliance with recent legislative enactments and completely overhaul the former law regarding injunctions to foreclosure sales. This note provides a summary of the new rules along with an analysis of the significant changes they implement.

The impetus for the reexamination of the existing rules was emergency legislation passed by the Maryland General Assembly in April, 2008, respecting the process for foreclosures of residential mortgages and deeds of trust. However, the practitioner must remember that the rules apply to commercial as well as residential foreclosures, and a practitioner whose focus is mainly commercial might be caught unaware of many of the changes.

The rules related to foreclosure are contained in Chapters 100 and 200, Title 14 of the Maryland Rules of Procedure, entitled "Sales of Property." There are only two rules in Chapter 100. Maryland Rule 14-101 addresses the location of a public sale of an interest in real property and contains only stylistic changes. Maryland Rule 14-102 is the procedure by which a foreclosure purchaser is to obtain a judgment awarding possession. There are significant changes in this rule which will be addressed later in this note.

The rule changes in Chapter 200 which will be considered here are:

Md. Rule 14-202. Definitions

Md. Rule 14-205. Conditions precedent to the filing of an action

Md. Rule 14-206. Petition for immediate foreclosure against residential property

Md. Rule 14-207. Pleadings; court screening

Md. Rule 14-208. Subsequent proceedings if no power of sale of assent to a decree

Md. Rule 14-209. Service in actions to foreclose on residential property; notice

Md. Rule 14-210. Notice prior to sale

Md. Rule 14-211. Stay of sale; dismissal of action

Md. Rule 14-212. Alternative dispute resolution

Md. Rule 14-202. Definitions

Three of the definitions contained in Md. Rule 14-202 merit treatment in this analysis. The first is the definition of "Borrower" under Md. Rule 14-202(b), defined expansively to include anyone with a personal obligation to pay the debt secured by the lien instrument, including the maker of the note secured by an indemnity deed of trust. This definition must be read in conjunction with the obligations of the person bringing the foreclosure action to provide service of process under Maryland Rules 14-206 and 14-209, notice of sale under Md. Rule 14-210, and the right of the Borrower to move to stay the sale under Md. Rule 14-211, all of which will be discussed below. Since traditional *in rem* jurisdiction requires notice only to those persons with an interest in the property, the requirement to provide notice to those who may have a personal obligation but who do not have a property interest, such as a guarantor, is a significant expansion of traditional notice requirements. Counsel is cautioned to make sure all documents are gathered from the secured party and reviewed so that service and notice can be provided to all persons entitled to it.

"Residential property" is defined in Md. Rule 14-202(i). The statutory definition of "residential property" contained in Md. Code Ann., Real Prop., § 7-105.1(a), covers real property "improved by four or fewer single-family dwelling units that are designed principally and are intended for human habitation." The rule definition tracks the statutory definition and adds that individual residential condominium units are covered and that time share units are not. These additions resolve questions that were raised following the legislative enactment as to the scope of the legislative definition.

"Statutory lien", as defined in Md. Rule 14-203(l) is a lien on property created by a statute providing for foreclosure in the manner specified for foreclosure of mortgages. Most commonly, this will be condominium or homeowner's association liens established under Md. Code Ann., Real Prop., Title 14, Subtitle 2, (Maryland Contract Lien Act). Recently, as part of another statutory reform, ejectment actions were barred as a remedy for unpaid ground rents. Ejectment actions were replaced with a foreclosure action. Md. Code Ann., Real Prop., § 8-402.3(d). Foreclosures of these types of liens are brought within the ambit of these rules under Md. Rule 14-201(a).

Md. Rule 14-205. Conditions precedent to the filing of an action

Maryland Rule 14-205(b), tracking the legislation, adds new conditions precedent to the filing of a foreclosure action by requiring that the action may not be filed until 90 days "after a default for which the lien instrument lawfully allows for sale" and 45 days after the notice of intent to foreclose was sent, unless otherwise ordered by the court in granting one of the four statutory exceptions allowing the immediate docketing of the foreclosure action, discussed further below.

Md. Rule 14-206. Petition for immediate foreclosure against residential property

The statute authorized the secured party to file a petition for immediate foreclosure with the Circuit Court, but provided absolutely no guidance as to how the Circuit Court should exercise that authority. Maryland Rule 14-206 created a new procedure that provided the missing guidance.

The rule requires the secured party to allege facts with particularity, under oath or supported by affidavit, that one of the four statutory exceptions exist, i.e., that the debt was obtained by fraud or deception, that no payments have ever been made on account of the debt, that the property subject to the lien has been destroyed, or that the default occurred after all stays have been lifted in a bankruptcy proceeding. The secured party is required to send copies by certified and first-class mail to each borrower and the record owner and is to include a notice that a response is to be filed within 10 days. The secured party is then obligated to file an affidavit of service.

A response is required to be filed within 10 days and is to allege facts with particularity, under oath or supported by affidavit, just as is required for the petition. A copy is to be served on the petitioner, and proof of service is required.

If there is a genuine dispute of material fact as to whether the petitioner is entitled to the relief requested, the court may not grant the petition without a hearing. Otherwise the court may grant the petition with or without a hearing.

The rule also clarifies that the order to docket or the complaint to foreclose will be filed in the same action as the petition.

The non-waiver provisions of Md. Rule 14-206(b)(2) create a huge trap for the unwary. If no response is filed to the petition, no defenses are waived. This means that, in the context of a motion to stay under Md. Rule 14-211, or in the context of exceptions to the foreclosure sale, the borrower or other interested party has the right to challenge whether or not the secured party was entitled to the exception. If the secured party was held not to have been entitled to the exception, the action would be dismissed because the notice of intent to foreclose had not been sent.

The practitioner is urged to consider carefully the viability of the petition under Md. Rule 14-206, even if it is clear that one of the exceptions exist. If the secured party has not already sent the notice of intent to foreclose (NOI), counsel will normally send a NOI to foreclose and put the commencement of the foreclosure action on hold for 45 days for the NOI to expire. If counsel chooses not to send the NOI in favor of filing this petition, there is the time spent drafting and filing the petition. After service of the petition, one must wait 10 days before presenting it to the court, and that is likely extended for another three days pursuant to Md. Rule 1-203(c). If a response is filed raising a genuine dispute of material fact, a hearing will have to be scheduled. If no response is filed, the defense is not waived. It will be a rare case where the week or two that might be gained will be worth the detriments of using this procedure.

Md. Rule 14-207. Pleadings; court screening

The title to this section is potentially a misnomer, since, in the case of the lien instrument containing a power of sale, the action is commenced by filing an order to docket. An order to docket is not a pleading. It does not raise issues to be controverted or tried. *Saunders v. Stradley*, 25 Md. App. 85, 333 A.2d 604 (1975); *Pacific Mortgage & Investment Group v. LaGuerre*, 81 Md. App. 28, 566 A.2d 780 (1989). An "assent to a decree" is a provision in the lien instrument assenting, in the event of a specified default, to the entry of an order for the sale of the property subject to the lien. Md. Rule 14-202(a). If a lien instrument contains an assent to a decree or the lien instrument contains neither a power of sale nor an assent to a decree, the action is commenced by filing a complaint. No process issues where there is a power of sale or an assent to a decree.

The documents required as attachments and exhibits have become a good deal more complex. However, one benefit to the practitioner is that clerk certified copies of record documents, such as the lien instrument, are no longer required, and the secured party may provide an affidavit that the provided copy is a true and correct copy of the original. A suggested best practice is to download a copy of the instrument from <http://mdlandrec.net> rather than relying that a

copy provided by the secured party or the abstractor contains all pages.

In all foreclosures, attachments to the complaint or the order to docket will include (1) a copy of the lien instrument, supported by affidavit that it is a true copy, (2) an affidavit of the right to foreclose and the statement of debt, (3) a copy of any separate note or debt instrument supported by an affidavit that it is a true copy and certifying its ownership, (4) a copy of any deed of appointment of substitute trustee or assignment for the purpose of foreclosure, supported by affidavit, (5) a military affidavit as to any individual defendant and (6) a statement as to whether or not the property is residential property. In the case of foreclosures of residential property, there shall be additionally attached papers required by Md. Code Ann., Real Prop., § 7-105.1(d), which shall include a consumer notice, a copy of the notice of intent to foreclose and a supporting affidavit.

The rules iteration of the military affidavit requirement corrected an error that was contained in a legislative enactment. The legislative enactment required an affidavit that the individual defendant was not a service member. However, the Servicemembers Civil Relief Act, 50 U.S.C. *Appendix*, § 511 allows foreclosure in certain instances, such as when the service member was a service member at the time the mortgage originated. Maryland Rule 14-207(b)(5) recognizes this by requiring affidavit of nonmilitary service or "that the action is authorized by the Act."

Nonetheless, since the affidavit is required as to any defendant who is an individual and the term "defendant" is not otherwise defined in these rules concerning the *in rem* foreclosure proceeding, it is unclear whether military service of certain "borrowers" who do not hold an interest in property creates an impediment to the foreclosure proceeding.

The practitioner should also note that military affidavits, like all other affidavits, are supposed to be factually specific and not conclusory. Circuit Courts in Maryland have generally become more aware of detail in foreclosure cases, and it is important for the practitioner to factually research the content of the military affidavit.

Maryland Rule 14-207(e) is of note. It authorizes a Circuit Court, as part of its case management, to adopt procedures to screen foreclosure actions. The Court is authorized to give notice to the plaintiff of the alleged deficiencies and that the action will be dismissed without prejudice if the plaintiff does not demonstrate within 30 days that the papers are legally sufficient or that the deficiency has been cured.

Md. Rule 14-208. Subsequent proceedings if no power of sale or assent to a decree

If there is no power of sale or assent to a decree in the lien instrument, process (a summons) shall issue and be served under the general rules for service in *in rem* cases, unless the property is residential, in which event service is required under Md. Rule 14-209.

Md. Rule 14-209. Service in actions to foreclose on residential property; notice

There is no requirement under Maryland law for either service or notice of the commencement of a foreclosure action, for property other than residential property. The legislature decided that copies of the original papers should be personally served and the rule expands that by requiring both the "borrower" and "record owner" be served. The papers may be delivered or they may be left with a resident of suitable age and discretion at the dwelling house or usual place of abode of the person being served. If on at least two different days good faith effort to serve was unsuccessful, service may be accomplished by mailing, by certified mail and first class mail and by posting a copy of the papers "in a conspicuous place on the residential property." Service is complete when the property has been posted and mailings have been placed in the mail. The original papers filed will often contain 50 to 75 sheets of paper, and service by posting and mailing to two co-owners can literally take a ream of paper.

As noted earlier, the significant legislative changes that were the impetus for these rule changes took place in the 2008 session of the Maryland General Assembly. There were a couple of legislative changes coming out of the 2009 session which needed to be treated in the rules. Md. Code Ann., Real Prop., § 7-105.9, was the legislature's effort to deal with the impact of foreclosures on tenants of the mortgagor being foreclosed. The law requires three different

mailings to the occupant, each of which contains notice of the action being taken and referral to community resources. Further, the notices require specific legends on the front of the envelope in 12 point type. These notices need only be mailed by first-class mail. Notice needs to be sent regarding the docketing of a foreclosure action, the scheduling of the sale, and following the entry of the judgment awarding possession.

The other legislative change is contained in Md. Code Ann., Real Prop., § 14-126(c). This is legislative authority to a county or municipal corporation to enact a local law requiring notice to the county or municipal corporation of the commencement of a foreclosure action. As of the time of the preparation of this note, only Prince George's County has enacted such a local law. The practitioner should keep in mind that Prince George's County's local law carries with it a \$50 a day fine for noncompliance, and since no specific method of delivery is specified, it is imperative that the practitioner keep appropriate records to be able to establish compliance. The practitioner is cautioned there is no central repository of listing which counties or municipalities may have enacted such a local law. The practitioner must be aware whether or not the property being foreclosed is in a municipality and, if it is, whether or not the municipality has enacted a local requirement under the State legislative authority.

These legislative changes have been mentioned in connection with Md. Rule 14-209 because this one rule captures the requirements for proof of service and proof of providing notice to all of these disparate actors, i.e., borrower, record owner, occupant, and, if enacted locally, county or municipal corporation. The essential take-away to the practitioner, however, is that Md. Rule 14-209 requires that all proofs of service of the commencement of the action be filed in the court case "promptly and in any event before the date of the sale." The failure to timely file the affidavits of service or of providing notice can be cause for the court to refuse to ratify the sale. It is again worth reminding practitioners, as well, that affidavits are to contain factual averments sufficient to let the court conclude that service was properly effected.

Md. Rule 14-210. Notice prior to sale

Notice of sale by publication is unchanged from prior law for residential and non-residential property. Notice of the time, place, and terms of the sale must be published in a newspaper of general circulation in the county in which the action is pending once a week for three successive weeks. The timing schedule is given, and under that schedule, if the publications are on, for example, Wednesday, the sale may take place on any day beginning on the Thursday after the last publication and ending on the following Tuesday. Proof of publication is traditionally established by publisher's certificate. The prior rules made no mention as to how publication is established, and the current rules do not correct this apparent oversight.

Aside from the notice of sale to occupants and the expanded concept of the "borrower" as discussed above, notice of the sale by certified mail and first-class mail remains largely unchanged. Notice of the time, place, and terms of sale must be sent to the borrower, the record owner, and the holder of any subordinate interest in the property, as well as to the county or municipal corporation in which the property is located. Notice shall be sent not more than 30 days and not less than 10 days before the date of the sale, and notice to the county or municipal corporation in which the property is located must be sent not less than 15 days before the sale.

The practitioner needs to remember that, in the case of residential property, the sale cannot be scheduled sooner than 45 days after completion of service of the original papers.

Md. Rule 14-211. Stay of sale; dismissal of action

This rule is entirely new and replaced the former injunction procedure in foreclosure actions. This rule gives standing to a broad range of actors to file a motion to stay a foreclosure, including "a person who claims an equitable interest in the property." The borrower, who, as previously noted, may not have an interest in the property, is still given standing.

A motion to stay by the borrower or record owner, unless time is extended for good cause, must be filed within 15

days after service. A motion filed by any other person who has standing must be filed within 15 days after the movant first becoming aware of the action.

A motion to stay is required to be under oath or supported by affidavit and must state with particularity the factual or legal basis of the defense. It is to be accompanied by any supporting documents. It is also to be accompanied by a request for the discovery of any specific supporting documents in the possession or control of the plaintiff or the secured party. This is significant because this is the first recognition in the rules of a right of discovery in a foreclosure action, a right first discussed in the recent case of *Jones v. Rosenberg*, 178 Md. App. 54, 940 A.2d 1109 (2008).

The court has the power to deny the motion with or without a hearing if it was not timely filed and does not show good cause, if it "does not substantially comply with the requirements of this Rule," or if it does not state a valid defense. Otherwise, the court is required to set the matter for a hearing on the merits of the defense. If practicable, that hearing is to be held before the time of the scheduled sale. Otherwise it is to be held within 60 days after the originally scheduled date of sale.

If the hearing cannot be held prior to the date of sale, the court is given the authority to stay the sale on reasonable and necessary terms and conditions to protect the property and the interest of the plaintiff. Md. Rule 14-211(c) contains a list of the factors that the court may consider. The court may require the moving party to provide reasonable security for compliance and may revoke the stay upon a finding of noncompliance. The court is required to have a hearing on the conditions of the stay on the request of a party. However, the court is given the express authority to conduct the hearing by "telephonic or electronic means."

The court is also given the power to enter a scheduling order and is given the authority to enter a final determination of the motion.

This rule has received a lot of recent attention due to the Home Affordable Modification Program (HAMP) program. Under this program, participating servicers, and certain investors such as Fannie Mae and Freddie Mac, are required to perform certain analyses before proceeding to foreclosure sale. If the particular analysis is not completed, there is no right to foreclose. Consumers and consumer advocates have used Md. Rule 14-211 effectively to stay sales when there are claims that the servicer has not completed its HAMP analysis or failed to properly notify the mortgagor that there was no eligibility for a modification.

Md. Rule 14-212. Alternative dispute resolution

This is also a new rule authorizing mediation or other alternative dispute resolution in those cases in which a motion to stay has been filed and has not been denied. The practitioner should note that since the authority is subject to the provisions of the general court mediation rule, Md. Rule 17-103, it is not mandatory.

Md. Rule 14-102. Motion for Judgment of Possession

This rule contains substantial revisions to the prior rule and includes compliance with the federal Protecting Tenants at Foreclosure Act (PTFA) of 2009 (P.L.111-22). The motion may be filed by the purchaser at a foreclosure sale if the purchaser is entitled to possession and the person in actual possession fails or refuses to deliver possession. The motion is required to state the legal and factual basis for the movant's claim of entitlement to possession. Ordinarily, the foreclosing lender will be entitled to possession following default under the terms of the instrument and will therefore be entitled to bring the motion before the sale is ratified and the purchase money paid, as would be the circumstances applicable to a third-party purchaser. The motion must also state the facts by which the court can determine that the terms of the PTFA were met or are not applicable. The motion must be supported by a factually specific affidavit.

In order to eliminate varying local practices, the rule expressly provides that the court is not to issue any show cause order, summons or other process in connection with the motion. The motion is required to be served on the person

in actual possession and on "any other person affected by the motion," a phrase that is not further defined. If the person served is a party to the action or to the lien instrument, service can be affected under civil rules for service of subsequent papers, which normally means by first-class mail. A person served under this provision has 15 days to respond. Any other person served under this rule needs to be served personally with provisions for substituted delivery and for mailing and posting that are modeled after and similar to the requirements set forth in Md. Rule 14-209 for service in connection with the commencement of the action. Counsel should remember that if the person to be served is not a party to the action or to the lien instrument, the motion must contain a notice advising the person that any response to the motion must be filed within 30 days after being served or within any applicable longer time prescribed by Md. Rule 2-321(b) for answering the complaint and that a copy of Md. Rule 2-321(b) is to be attached to the notice.

While the rule does not expressly so provide, proof of service must be filed in the absence of a response, and it is recommended that the practitioner produce proof of service similar to that required for similar service under Md. Rule 14-209.

With respect to any response filed, it is interesting to note that if the person responding claims to be a bona fide tenant having a right to possession under the PTFA, the person responding is required to produce his or her lease or explain why it is not available.

If the time to respond passes and no response is filed, the court may enter a judgment awarding possession upon finding that the motion and supporting documents are compliant.

If the property is residential, Md. Rule 14-102(e) provides that the foreclosure purchaser must comply with the third notice requirement of Md. Code Ann., Real Prop., § 7-105.9, as discussed in connection with Md. Rule 14-209, i.e., notice to the occupant that an order for judgment of possession has been entered, and file an affidavit establishing that.

Final Comments

In Maryland, all foreclosure sales must be ratified, and there is an opportunity, prior to ratification, for the party with standing to file exceptions to the sale. The procedure for this was not changed under the new rules and is not included in this treatment, other than to say that it is governed by Maryland Rules 14-215(a), 14-305 and 14-306.

The reader of this note is also cautioned to refer to original source material in acting under these revised Maryland Rules as many nuances of the revised rules, particularly in relationship to the foreclosure of statutory liens, could not be covered.

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11 of 79 DOCUMENTS

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CALIFORNIA SENATE BILL 94

2010 Emerging Issues 4831

CALIFORNIA SENATE BILL 94--PRACTICAL ASPECTS OF NEW CALIFORNIA CIVIL CODE SECTIONS 2944.6 AND 2944.7

By William M. Hensley

January 19, 2010

SUMMARY: This Emerging Issue Analysis examines the foreclosure crisis that precipitated the passage of California Senate Bill 94, which added new Civil Code §§ 2944.6 and 2944.7, as well as provides practical tips to clients looking for loan modification help and explores some unanswered issues for lawyers arising after the passage of SB 94.

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ARTICLE: Introduction

Although the public may perceive that the foreclosure crisis is waning, recent statistics show that there are more troubled loans and foreclosures pending in California as measured by the July 2008 peak in actual foreclosures. This crisis obviously inspired the enactment of California Senate Bill 94 (Calderon) into law effective October 11, 2009. New California Civil Code §§ 2944.6 and 2944.7 were passed to protect residential loan borrowers from predatory attorneys who have a practice of collecting advance fees for certain specified loan modification or forbearance activities. This Emerging Issue Analysis looks at the crisis precipitating the passage of SB 94, the legislation itself, the State Bar's interpretation of the new statutory language, and tips to borrowers seeking the services of attorneys specializing in loan modifications or forbearances (both from the California State Bar, the California Department of Real Estate, and this author).

The Mounting Foreclosure Crisis

Statistics from CalculatedRisk demonstrate that, for August 2009, notice of trustee's sales filings in California on residential dwellings increased by 31.6% from June 2009. For the same month, foreclosures scheduled for sale rose to 124,874, a 104% leap from those scheduled in June 2009. The average California foreclosure has a total loan balance of \$425,134 on a home now worth only \$236,739.

Foreclosure Radar has information that is just as sobering for California residents facing foreclosure of their homes. Although July 2008 was a peak month for bank foreclosures, the number of foreclosures taken back by banks

rose 20.95% in October 2009 as compared to October 2008 levels. The inventory of scheduled foreclosures has grown by 131.36% since the July 2008 peak, due in large part to lender moratoriums or efforts by borrower and lender to mutually work out their loans.

For many borrowers facing foreclosures or desiring to challenge past foreclosures based on irregularities, impossible hurdles face them with respect to a residence that is as horribly underwater as the average statistics demonstrate. A large number of trial courts require that the borrower prove that he or she has adequate money to tender to pay off the delinquent loan installment or the entire loan if the debt was accelerated. This is the case even if the borrower alleges violations of federal statutes such as the Truth In Lending Act (TILA) or challenges the trustee's sale as irregular in nature [see, e.g., *Yamamoto v. Bank of New York*, 329 F.3d 1167, 1173, 2003 U.S. App. LEXIS 10665 at **14 (9th Cir. 2003), cert. denied, 540 U.S. 1149 (2004) (TILA rescission only granted on borrower's willingness to make a full delinquency tender); *Abdallah v. United Savings Bank*, 43 Cal. App. 4th 1101, 1109, 51 Cal. Rptr. 2d 286, 292, 1996 Cal. App. LEXIS 260 at ***14-15 (1996), cert. denied, 519 U.S. 1081 (1997) (borrower challenging nonjudicial foreclosure sale irregularity must tender full amount of indebtedness); *Karlsen v. American Sav. & Loan Assn.*, 15 Cal. App. 3d 112, 117, 92 Cal. Rptr. 851, 854, 1971 Cal. App. LEXIS 879 at ***8-9 (1971) (same)]. Frequently, the borrower does not have the money to make this tender or even provide a bond to support a preliminary injunction in an amount below the full tender price. However, some attorneys have engaged in regular conduct in their practices requiring a distressed borrower-client to pay advance fees for loan modification advice that would likely not be able to help the borrower-client save or regain his or her home.

The California State Bar Responds

Alarmed by lawyers who were preying on vulnerable borrowers, the State Bar of California began to investigate and discipline lawyers for misconduct related to loan modifications in record numbers. In a fairly dramatic break from past protocol beginning in the fall of 2009, the Bar's Interim Chief Trial Counsel waived investigation confidentiality in order to identify to the public those lawyers under suspicion for loan modification/forbearance malfeasance.

Many of the attorneys being named by the State Bar are alleged to have taken fees for promised services and then failed to perform those services, communicate with their clients, or return the unearned fees. Others have misrepresented that they specialize in loan modification so that homes are lost because they cannot prevent the foreclosure, cannot obtain an injunction pending a judgment on the borrower's claims, or do not have expertise in loan workouts with banks. Still others affiliate with foreclosure consultants who unfairly take advance fees or overplay their expertise in the area. (For more information on California statutes relating to mortgage foreclosure consultants, see Cal. Civ. Code §§ 2945-2945.11.)

The State Bar's Office of Trial Counsel (OTC) found that many of the offending attorneys are associated with firms that use telemarketers or phone banks to sign up clients without regard to the facts of the individual case or without regard to whether the client can be helped.

Almost one-quarter-around 800 cases-of the OTC's active investigations are related to foreclosure complaints, with the office experiencing a 58% increase in active investigations since 2008 due in large part to the increase in complaints about attorneys offering loan modification services.

Recently, monthly issues of *The California Lawyer* in 2009 increasingly have published lists of attorneys being investigated or disciplined for loan modification activities.

The California Legislature Responds

SB 94, which added new sections 2944.6 and 2944.7 to California's Civil Code, took effect on October 11, 2009, and enacted various reforms, although they are limited to mortgages or deeds of trust securing residential property containing four or fewer dwelling units (although owner occupancy is not required).

Cal. Civil Code § 2944.7 makes it unlawful for any person or entity who negotiates, attempts to negotiate, arranges, attempts to arrange, or otherwise offers to perform a mortgage loan modification or other form of mortgage loan forbearance for a fee or other compensation from the borrower, to do any of the following:

- Claim, demand, charge, collect, or receive any compensation until after the person has fully performed each and every service the person contracted to perform or represented that he or she would perform;
- Take any wage assignment, lien, or other security to secure the payment of compensation; or
- Take a power of attorney from the borrower for any purpose.

Cal. Civil Code § 2944.6 requires mortgage loan workout persons providing services to a borrower for a fee or compensation to deliver to the borrower a 14-point bold type statement containing mandatory language that notifies the borrower that (1) the same services are available for free, (2) it is not necessary to pay someone for the services, and (3) a list of approved nonprofit housing counseling agencies are available through the U.S. Department of Housing and Urban Development. A translated copy of this statement must be provided to a borrower that speaks Spanish, Chinese, Tagalog, Vietnamese, and Korean if the loan modification/forbearance services are offered or negotiated in one of these languages.

Also effective October 11, 2009, new Cal. Business & Professions Code § 6106.3(a) provides for the imposition of discipline if a lawyer violates Cal. Civil Code § 2944.6 or 2944.7.

For more information on mortgage fraud legislation, see Real Estate Financing, Ch. 5A, *Mortgage Fraud Legislation*, § 5A.02 (LexisNexis Matthew Bender).

OTC's Interpretation of Some Unanswered Issues From This New Legislation For California Lawyers

The State Bar's OTC has provided some interpretive commentary on some unanswered issues, indicating it will enforce the new statutory language consistent with these interpretations:

- **Retroactivity**-Advance fees collected before October 11, 2009, are not impacted, but advance fees based on agreements entered into before October 11, 2009, where collection occurred after October 11, 2009, must be fully refunded;
- **Depositing Fee Into Client Trust Account**-Because new Cal. Civil Code § 2944.7(a)(1) uses the broad language "receives," this provision makes it unlawful for an attorney to collect a fee, place that fee in a client trust account (or general or other account), and then draw down against that fee even after services have been fully performed; and
- **Requesting Retainers**-Even a "retainer" cannot be collected under the new legislation given the breadth of the language "any compensation."

For additional information on the OTC's interpretations, see

<http://calbar.ca.gov/calbar/pdfs/ethics/Ethics-SB94-FAQs.pdf>.

Practical Tips for Borrowers Seeking Loan Modification/Forbearance Legal Advice

Here are some tips for borrowers to follow to avoid potential fraud or problems when seeking to choose an attorney offering loan modification/forbearance services:

- Avoid offices that do not expressly identify the name of the attorney responsible for overseeing the entire office.
- Avoid offices where the attorney in charge or staffed on loan modification/forbearance issues will not meet personally with you as a prospective client.

- Generally avoid legal offices that advise the borrower:
- to stop paying the existing mortgage;
- to steer the payment to some third party;
- to transfer title to a third party; or
- to enter into a creative "leaseback" arrangement.
- Avoid lawyers who illegally request advance fees, powers of attorneys, or other upfront compensation arrangements.
- Avoid attorneys who make promises or guaranties of success or prominently tout themselves based on testimonials that sound too good to be true.
- Avoid offices that claim they are a loan modifiers operating under a California Finance Lender's license issued by the California Department of Corporations (an unlawful practice, according to the Corporations Commissioner).
- Avoid lawyers that request you to sign documents before giving you a chance to read them or before giving you the newly mandated Civil Code § 2944.6 statement.
- Avoid persons with any high pressured sale types of presentation.
- Avoid dealing with attorneys that are unlicensed or not licensed in the state where the residence is located.
- Check out the attorney on the State Bar "attorney search" location for the presence of disciplinary proceedings (*see* <http://members.calbar.ca.gov/search/member.aspx>).
- Request information from the prospective attorney about past clients or attorney colleagues that can substantiate the experience and expertise of the attorney being considered for retention.
- "Surf" the Internet about the attorney, seeking Martindale Hubbell (*see* <http://www.martindale.com/>) or Avvo.com information and rankings.

For more "red flag" tips for the client-borrower, *see* the California Department of Real Estate's "Consumer Alert" on the subject first issued in March 2009 (but revised as of November 2009), *available at*

http://www.dre.ca.gov/pdf_docs/FraudWarningsCaDRE03_2009.pdf.

Additional Cross References:

California Real Estate Law & Practice (LexisNexis Matthew Bender):

- Ch. 100, *Methods of Financing*
- Ch. 111, *Deeds of Trust and Mortgages*
- Ch. 120, *Representing a Client After Default*
- Ch. 123, *Nonjudicial Foreclosure*

Real Estate Financing/Commercial, Ch. 5A, *Mortgage Fraud Legislation* (LexisNexis Matthew Bender).

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12 of 79 DOCUMENTS

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Avoiding Recognition of Taxable Income

2009 Emerging Issues 4786

Avoid Recognition of Taxable Income Upon Cancellation or Modification of Debt for Distressed Mortgages

By David R. Tavolier

December 31, 2009

SUMMARY: When a borrower of a distressed loan works out a solution to relieve their financial situation, that borrower can face a new burden of recognizing cancellation of debt as taxable income. In this article, Taft Stettinius & Hollister partner, David R. Tavolier, discusses options for the borrower to consider in attempting to avoid the recognition of such cancellation of debt.

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ARTICLE: In this environment of distressed mortgage loans, many borrowers attempting to work out those distressed loans will be confronted with the added burden of having to recognize "cancellation of indebtedness income" ("COD Income"). U.S. income tax rules generally require a borrower to recognize COD Income whenever the borrower's indebtedness is reduced or when the borrower (or certain related parties of the borrower) reacquire the debt at a discount. The amount of COD Income that must be recognized is generally equal to the amount of the reduction in the principal amount of the debt or the discount for reacquiring the debt. This COD Income is then included in the borrower's income at ordinary income tax rates. For example, if a taxpayer previously borrowed \$5 million from a lender and subsequently the lender either agrees to reduce the principal amount of the loan to \$3 million or permits the taxpayer to discharge the loan for a payment of only \$3 million, the taxpayer will generally be required to recognize COD Income of \$2 million. Fortunately, there are numerous exceptions to the general rule that permit the borrower to avoid recognizing COD Income upon the taxpayer's debt being reduced or repaid at a discount. The more significant exceptions are briefly summarized below. As indicated below, many factors beyond the scope of this article must be considered in planning for and understanding the consequences arising from cancelling and modifying indebtedness, and it is best to consult one of our tax lawyers before entering into a transaction that may involve COD Income.

■ **Insolvency and Bankruptcy Exceptions** - If the indebtedness is discharged or cancelled while the borrower is insolvent (i.e., the borrower's liabilities exceed the borrower's assets), the borrower can generally exclude the COD Income equal to the amount by which the borrower is insolvent. For purposes of these rules, a borrower is insolvent to the extent that the borrower's liabilities exceed the fair market value of the borrower's assets. COD Income can also be avoided when the indebtedness is cancelled or reduced in connection with a Federal Bankruptcy proceeding. Under this bankruptcy exception, the entire amount of debt that is extinguished or reduced qualifies for the exception without

regard to the extent to which the borrower is insolvent. Whenever the insolvency or bankruptcy exceptions apply, the borrower is required to reduce certain tax attributes by the amount of COD Income that is excluded. For example, if the taxpayer has other assets, net operating losses, general business tax credits or capital losses, it will be required to reduce its basis in those assets and/or the amount of those losses or credits by the amount of excluded COD Income. In the case of debt relating to partnerships and limited liability companies, it is important to remember that these exceptions apply at the partner or member level. Therefore, the exceptions will apply only if the particular partner or limited liability company member is insolvent or is filing for bankruptcy. Bankruptcy or insolvency of the partnership or limited liability company entity of which the taxpayer is a partner or member is not sufficient for these exceptions to apply to COD Income arising from debt of the partnership or LLC.

- **Qualified Real Property Business Indebtedness** - Another exception applies to the cancellation or reduction of indebtedness that is secured by real property used in a trade or business and that is incurred or assumed to acquire, construct, reconstruct or substantially improve the property. Debt incurred to refinance such property also qualifies to the extent it does not exceed the principal amount of the refinanced debt. This exception is elective and applies to property owned by individuals, partnerships, limited liability companies, and S corporations. It does not apply to entities classified as "C" Corporations. If utilized, the tax basis of the borrower's depreciable real property is reduced by the amount of COD Income excluded.

- **Qualified Principal Residence Indebtedness** - Another exception permits taxpayers for a limited period to exclude COD Income arising from indebtedness used to acquire (or refinance) the taxpayer's principal residence, generally up to the amount of \$2 million. As with the Qualified Real Property Business Indebtedness, the amount of COD Income that is excluded reduces the taxpayer's taxable basis in the residence. This exception was recently added to help alleviate the burden of COD Income arising from debt forgiveness in connection with the housing crisis. It applies only to COD Income arising from the cancellation or reduction of indebtedness before January 1, 2010.

- **New Election to Defer COD Income** - The American Recovery and Reinvestment Act of 2009 added a new provision that permits taxpayers to elect to defer COD Income arising from a "reacquisition" of the debt in 2009 or 2010. The COD Income must be included in gross income ratably over a 5-year period beginning generally in the 2014 tax year. This provision applies only to borrowings made by a C Corporation or otherwise in connection with a trade or business. The term "reacquisition" includes a complete forgiveness of the debt. A taxpayer will have to consider many limitations in evaluating whether or not to utilize this deferral election. For example, COD Income deferred under the election will not qualify for the bankruptcy, insolvency or qualified real property business indebtedness exclusions described above and upon certain events, the deferral may be accelerated (e.g. sale of substantially all of the borrower's assets, liquidation of the borrower or cessation of the borrower's business activities). In the case of partnerships, S corporations and limited liability companies, the election is made at the entity level. Certain other special rules apply to partnerships and limited liability companies. Therefore, particular care must be taken when the election is made with respect to indebtedness of a partnership or limited liability company.

- **Purchase Price Adjustments** - COD Income can generally be avoided when the indebtedness being cancelled or reduced is debt of the purchaser of the property to the seller of the property ("a seller financed sale"). In those cases, the amount of COD Income is treated as a purchase price reduction, thereby reducing the buyer's basis in the purchased property.

- **Deductible Liabilities** - No COD Income is required to be recognized to the extent that the borrower's payment of the discharged liability would give rise to a deduction to the borrower.

- **Capital Contributions** - In the case of corporations, a shareholder may contribute debt that the corporation owes to the shareholder and the corporation will not normally be required to recognize COD Income.

- **Satisfaction by Receipt of Corporate Stock or Partnership/LLC Interests** - If a corporation, partnership or limited liability company satisfies its debt to a borrower by issuing an equity interest to the borrower, the entity will recognize COD Income only to the extent the debt being extinguished exceeds the fair market value of the equity interests being issued to the lender. However, in these types of transactions, the lender receiving the stock is not entitled to recognize immediately a loss deduction equal to the COD Income being recognized by the corporation. Proposed regulations similarly provide that in the partnership/LLC context, the lender will not be entitled to a loss deduction upon receipt of the partnership or LLC membership interest.

- **Foreclosure of Non-recourse Debt** - When a borrower conveys property to a lender that secures an indebtedness that

is non-recourse to the borrower (either in connection with a foreclosure or in contemplation of a foreclosure action), the borrower does not recognize COD Income. Instead, the transaction is treated as a sale transaction and the borrower recognizes capital gain (or loss) to the extent of the difference between the principal amount of the indebtedness and the borrower's tax basis in the property being extinguished.

RELATED LINKS: For related information see

■ 2009 Emerging Issues 4724

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13 of 79 DOCUMENTS

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Cooperative Solutions

2009 Emerging Issues 4763

Cooperative Solutions for Distressed Properties

By Monica Gearding

December 28, 2009

SUMMARY: The current economy has resulted in many real estate projects that do not generate sufficient income to pay the operating cost of and the debt service on the project. In this article, attorney Monica Gearding suggests the notion of 'cooperative' solutions where the borrowers and lenders can work together to minimize the impact of this problem for both parties.

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ARTICLE: The current economy has resulted in many real estate projects that do not generate sufficient income to pay the operating cost of and the debt service on the project. Borrowers, unable to refinance and generate sufficient income, are looking for a way out. Lenders, trying to avoid keeping non-performing projects in their portfolios, are looking for ways to turn these distressed projects around. Borrowers and lenders need creative, cost effective solutions. In many situations, if the borrower and lender can work together, they can maximize the benefits for each. Transactions like deeds in lieu of foreclosure or "cooperative" foreclosures are becoming more common as they offer benefits to both a borrower and a lender.

"Cooperative" Foreclosures: A Cost Effective Alternative

For borrowers and lenders the word "foreclosure" sounds ominous. A "cooperative" foreclosure, however, can be a very cost effective solution for both the borrower and lender of a distressed real estate project. A "cooperative" foreclosure can be especially beneficial for a project which has a value equal to or less than the outstanding balance on lender's first mortgage loan.

The borrower benefits from a "cooperative" foreclosure because it is relieved of the distressed project and its guarantors may be able to reduce their financial exposure. In addition, the time, administrative costs, and legal costs can be significantly less than traditional foreclosure proceedings or non-judicial workout alternatives. The lender also benefits from the reduced costs and shorter resolution time, but the most significant benefit to the lender may be the

continued operation of the improvements on the real estate and a smooth transition which, for certain projects, is critical to maximizing the value of the project collateral.

The "cooperative" foreclosure is beneficial over other work-out solutions as the judicial process may create a greater protection against claims from subordinate creditors. This is a distinct advantage over a deed in lieu of foreclosure, in which subordinate liens remain [see discussion of Deeds in Lieu of Foreclosure]. A disadvantage is that it is a more public process, so it may not provide the confidentiality available with other solutions.

A basic "cooperative" foreclosure transaction may look like this:

- Lender may require a pre-workout agreement setting forth the parameters and terms of the workout negotiations, the status of the loan and loan documents and any information lender will require from borrower to aid in its workout discussions.
- Certain due diligence is performed, including a title search to identify any subordinate lien holders that should be included in the transaction.
- Borrower and lender will negotiate the terms of the basic transaction agreement (i.e. the workout agreement), which may include: settlement of any personal guarantees; operation of the project; appointment of a receiver; allocation of liability; payment of debts for which there may be personal liability; transfer of property; settlement of deficiency or payment of surplus; and content and filing of court documents.
- Receiver, if applicable, is selected.
- The court documents are filed, including the Appointment of Receiver, if applicable, Foreclosure Complaint and Agreed Decree in Foreclosure.
- Transfer documents are executed, delivered and recorded.

The advantages and concerns for both borrower and lender in a "cooperative" foreclosure are similar to those presented by a deed in lieu of foreclosure transaction.

More complex "cooperative" foreclosure transactions that deal with more than real estate will present additional issues not discussed above, such as those relating to subordinate creditors, employee compensation and benefits, tax matters, preferences and other bankruptcy considerations.

RELATED LINKS: For more on mortgage foreclosure, see

- 2008 Emerging Issues 2976

For more information on mortgage foreclosure, see Real Estate Financing

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14 of 79 DOCUMENTS

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Mills on PLRs 200810016 & 200810017

2009 Emerging Issues 4723

PLRs Enhance Planning Opportunities for Like Kind Exchanges Involving Related Parties

By Patricia Hughes Mills

December 14, 2009

SUMMARY: Patricia Hughes Mills explains how private letter rulings enhance planning opportunities for like kind exchanges by confirming the parameters of a technique that allows a taxpayer who wants to dispose of a property to purchase replacement property from a related party, which may be helpful in situations where the taxpayer has trouble finding acceptable replacement property within the time frames required by I.R.C. § 1031.

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ARTICLE: Several private letter rulings have confirmed the parameters for an interesting tax planning opportunity involving related parties engaged in a like kind exchange. The technique allows a taxpayer who wants to dispose of a property to purchase the replacement property from a related party, which may be helpful in situations where the taxpayer has trouble finding acceptable replacement property within the time frames required by *I.R.C. § 1031*. In addition, the technique essentially allows basis to be shifted from one property to another property among related parties. This may be useful where a taxpayer wishes to dispose of a low-basis property. By exchanging that property with a high-basis property owned by a related party, the related group can ultimately sell the property they wish to dispose of, but that property will carry the high-basis upon its disposition.

Related party exchanges are generally governed by *I.R.C. § 1031(f)*, which provides that if a taxpayer engages in an exchange which otherwise qualifies under § 1031 with a related party, n1 gain will have to be recognized if either the taxpayer or the related party disposes of the property received in the exchange within two years of the exchange. n2 The concern in many of these transactions is *I.R.C. § 1031(f)(4)*, which states that *I.R.C. § 1031* will not apply to any transaction or series of transactions structured to avoid the purpose of § 1031(f). However, the two-year period in § 1031(f) is essentially treated like a safe harbor. In FSA 200137003, where related parties engaged in a like kind exchange, and one of the parties disposed of its property received in the exchange more than two years after the original exchange, the Service stated:

We believe that the two-year rule in section 1031(f)(1)(C) is a safe harbor that precludes application of section 1031(f)(1) to any transaction falling outside that period. Thus, a taxpayer acquiring property from a related party can avoid application of the rule in section 1031(f)(1) merely by waiting until after the two year period to dispose of the

property.

Therefore, *I.R.C. section 1031(f)(4)* does not apply to this situation because there was no attempt by either party to circumvent the rules. Rather, the parties merely took advantage of what Congress allowed them by enacting the two-year rule. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). In our view, the purpose of section 1031(f)(4) is to stop taxpayers from violating the two-year rule, and not to preclude taxpayers from planning to dispose of property after the two-year period. Thus, if a taxpayer exchanges property with a related party, intending to dispose of the replacement property after the two-year period, section 1031(f)(4) would not require recognition of the original gain. This analysis would not apply, however, if the exchange were a sham.

A similar technique was recently used in identical private letter rulings: *PLR 200810016* and *PLR 200810017*. In those rulings, the AB LLC ("AB"), which owned Blackacre, and the CD LLC ("CD"), which owned Greenacre, were related parties. AB agreed to sell Blackacre to an unrelated buyer ("Buyer"), and wanted to do so as part of a § 1031 exchange by acquiring Greenacre as its replacement property. CD will acquire qualified replacement property so that its transfer of Greenacre will also qualify under § 1031. To facilitate their exchanges, AB and CD enter into exchange agreements with a qualified intermediary ("QI"). Pursuant to the exchange, AB will transfer Blackacre to QI, QI will sell Blackacre to Buyer, acquire Greenacre from CD, and transfer Greenacre to AB to complete AB's exchange. Similarly, QI will receive Greenacre as part of CD's like kind exchange, will acquire New Property from an unrelated Seller and transfer it to CD to complete CD's exchange. After all of the transactions are completed, Buyer will own Blackacre, AB will own Greenacre, and CD will own New Property. AB and CD agree not to dispose of their respective properties within two years of the exchange.

Note first of all that had AB and CD simply exchanged Blackacre for Greenacre and then CD sold Blackacre to Buyer, AB would not be entitled to nonrecognition because the related party (CD) disposed of the exchanged property within two years of the exchange. Assume for example that CD had just purchased Greenacre for \$100 and so had a \$100 basis and value in Greenacre, and assume that AB's basis in Blackacre was \$10 while its value was \$100. After the exchange, AB would hold Greenacre with a \$10 basis and CD would hold Blackacre with a \$100 basis. If the goal of the parties was to ultimately sell Blackacre (which had \$90 of gain in AB's hands), Blackacre could now be sold by CD for no gain (\$100 value with a substituted \$100 basis). However, since § 1031(f) essentially views the related parties as one person, the taxpayer is cashing out his or her investment, which is contrary to the purpose of § 1031, and AB's exchange would not be a nonrecognition transaction. AB and CD could of course have done a direct exchange of Blackacre for Greenacre and waited two years to sell Blackacre, but Buyer may not be willing to wait two years to acquire Blackacre.

Consequently, in *PLR 200810016* and *PLR 200810017*, the parties wanted to sell Blackacre to Buyer, but a simple exchange for Greenacre and subsequent sale for cash would have violated § 1031(f), since one of the related parties cashed out their investment. However, the Service in *PLRs 200810016 and 200810017* ruled that § 1031(f) did not apply to the transaction described above since:

the only subsequent disposition of replacement property contemplated by the parties is the use of the proceeds from the disposition of Greenacre by CD to acquire CD's replacement property in another exchange under § 1031, a nonrecognition transaction. Therefore, § 1031(f)(4) will not apply to require recognition of gain or loss in the exchanges of either related party. Both AB's exchange and CD's exchange are structured as like-kind exchanges qualifying under § 1031. There is no "cashing out" of either party's investment in real estate. Upon completion of the series of transactions, both related parties will own property that is of like kind to the property they exchange. Neither exchanger will receive cash or other non-like-kind property (other than some possible boot) in return for the relinquished property.

Using related parties in like kind exchanges can be helpful in locating acceptable replacement property and shifting basis from a high-basis property to a low-basis property. However, taxpayers must structure their exchange to either wait two years to cash out their investment, or sell the desired relinquished property in another qualified exchange.

[Return to Text](#)

n1 Related person for this purpose is defined in *I.R.C. § 1031(f)(3)* as any person bearing a relationship to the taxpayer described in *I.R.C. § 267(b)* or *§ 707(b)(1)*.

n2 Certain dispositions within two years will not trigger gain recognition, such as a disposition due to death or involuntary conversion, or where it is established to the satisfaction of the Secretary that neither the exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. See *I.R.C. § 1031(f)(2)*.

n3 See *Treas. Reg. § 1.1031(k)-1(g)(4)*.

n4 *I.R.C. § 1031(f)*. Likewise, simply putting a QI in the middle will not solve the problem. See *Rev. Rul. 2002-83, 2002-2 C.B. 927*.

n5 See *I.R.C. § 1031(d)*.

n6 Although even in the absence of *§ 1031(f)*, CD is unlikely to satisfy the "held for" requirement of *§ 1031*, CD does not need a nonrecognition exchange where there is no gain in Greenacre.

n7 Both the Ways and Means Committee Report and the Senate Finance Committee Print, describe the policy concern that led to enactment of *§ 1031(f)*: "Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151.

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15 of 79 DOCUMENTS

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Mills on Homeowners & Phantom Taxable Gain

2009 Emerging Issues 4724

Tax Consequences of the Home Affordable Modification Program (HAMP) and the Treatment of Debt Discharge

By Patricia Hughes Mills

December 14, 2009

SUMMARY: Patricia Hughes Mills sets out ways in which distressed homeowners may be able to eliminate phantom taxable gain when debt is discharged--including participation in the Home Affordable Modification Program (HAMP) program.

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ARTICLE: HAMP

The Obama Administration's Homeowner Affordability and Stability Plan offers qualifying taxpayers the opportunity to refinance or modify home loans in order to avoid foreclosure. n1 One component of this Plan - known as "HAMP" (the Home Affordable Modification Plan) - helps homeowners who have defaulted on their mortgage, or are at risk of defaulting, due to decreases in income or other hardships. Under HAMP, homeowners who make timely payments on their modified loans are eligible to have incentive payments made on their behalf by the federal government to their lenders. Each month that a homeowner makes a mortgage payment on time, the homeowner accrues an amount toward a Pay-for-Performance Success Payment. A payment of the accrued amounts is made annually, to reduce the principal balance on the homeowner's mortgage loan. Homeowners can receive principal reductions of up to \$1,000 per year for up to five years, such to a *de minimis* threshold.

What are the tax consequences of HAMP payments? Normally, the discharge of indebtedness is taxable income. n2 Certain exceptions are provided when the discharge occurs in bankruptcy, when the taxpayer is insolvent, and when the debt is qualified farm indebtedness, qualified real property business indebtedness, or qualified principal residence indebtedness (more about this below). n3 The HAMP payments, however, are not traditional debt discharge, but rather a payment made by another party to reduce the homeowner's mortgage balance. Payments made on behalf of a taxpayer are generally also income to a taxpayer. However, the I.R.S. has consistently held that payments made under legislatively provided social benefit programs for promotion of the general welfare are not includible in a recipient's gross income. n4 Consequently, the I.R.S. has ruled that the Pay-for-Performance Success Payments made under the

HAMP program promote the general welfare by helping at-risk homeowners, meet the requirements of the general welfare exclusion, and therefore are not income to the homeowner. n5

(Non-HAMP) Discharge of Indebtedness

Examples of (non-HAMP) debt discharge affecting homeowners. Outside of the HAMP program, homeowners may also face discharge of indebtedness either by a **foreclosure on their property** or by negotiating with the lender for a **modification of their home loan**. For example, homeowners in a foreclosure may have debt relief in the amount of the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt (typically the value of the residence). Thus, where a lender forecloses on a home currently worth \$180,000 in satisfaction of an outstanding loan balance of \$200,000, the taxpayer has \$20,000 of debt relief. Similarly, if instead of foreclosure that creditor agrees to restructure the loan and reduce the principal amount to \$180,000, the homeowner has \$20,000 of debt relief.

What are the tax consequences of the discharge of indebtedness under these circumstances? Although the general rule is that discharge of debt produces income to a taxpayer, n6 there are favorable rules available for homeowners with debt relief on *principal residences*. With respect to a modification of the loan balance (where the taxpayer keeps the home), or a foreclosure where the debt is recourse debt (that is, the taxpayer is personally liable for any deficiency), Congress provided a favorable result for homeowners in the Mortgage Forgiveness Debt Relief Act of 2007 [the "2007 Act"]. n7 As amended by the 2007 Act, *I.R.C. § 108* now specifically excludes from a taxpayer's gross income a discharge of qualified debt on a principal residence. Qualified principal residence indebtedness means acquisition indebtedness n8 with respect to a taxpayer's principal residence. n9 A taxpayer is entitled to relief from cancellation of indebtedness income of up to \$2 million of qualified principal residence indebtedness under this provision. n10 Note, however, that the relief provided by the 2007 Act applies to "acquisition" debt as defined in *I.R.C. § 163(h)(3)(B)*, and not to home equity loans (unless those loans are used for substantially improving a principal residence and otherwise fit within the definition of acquisition indebtedness). In the example above, if the debt is qualified principal residence indebtedness, a modification of the loan from \$200,000 to \$180,000 will produce \$20,000 of debt relief, which is excluded from income under *I.R.C. § 108*. Similarly, a transfer of the property in foreclosure (assuming recourse debt) will be treated as a sale of the property for the value of the residence (i.e., a sale for \$180,000), and debt relief of \$20,000, eligible for the *I.R.C. § 108* exclusion. n11

What if only a portion of the discharged debt is qualified indebtedness? If only a portion of the discharged debt is qualified principal residence indebtedness, the exclusion from income applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. n12 For example, assume a principal residence is secured by indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold in foreclosure for \$700,000 and the balance of \$300,000 of debt is discharged, the taxpayer may exclude only \$100,000 of the amount discharged from income under this provision. The balance of \$200,000 of debt discharge would be taxable income to the taxpayer unless another exception under § 108 applies. n13

Timing and Form. This relief from discharge of indebtedness income on qualified principal residence debt is available only for qualified principal residence debt discharged beginning January 1, 2007 and ending before January 1, 2013, n14 and must be reported on Form 982.

Discharge of indebtedness must be for the right reason. The exclusion from income will not apply if the discharge of indebtedness is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer. n15

Basis. The taxpayer must reduce the basis of his or her principal residence by the amount of any income that is excluded under this new provision. n16 While this means that the taxpayer will have more gain on the subsequent sale of a principal residence, that gain is likely to be taxed at capital gain rates or excluded under *I.R.C. § 121*, while the

taxpayer has avoided immediate ordinary income from the debt relief.

Nonrecourse debt and foreclosure takes slightly different treatment. The treatment is slightly different when the homeowner is not personally liable for the home mortgage (i.e., the debt is nonrecourse) and the residence is transferred in foreclosure. [A loan *modification* of a nonrecourse debt will be eligible for the *I.R.C. § 108* exclusion described above, since that creates discharge of indebtedness income. n17] Where a property is transferred in satisfaction of a nonrecourse debt, the transaction is treated as a sale of the property for the full amount of the debt, resulting in gain or loss to the extent that the debt is greater than or less than the basis of the property. n18 There is no discharge of indebtedness income since the entire debt amount is an amount realized in a sale. Continuing with the example above, assume that the taxpayer purchased a residence for \$200,000 with a \$200,000 loan (100% financed, resulting in a tax basis of \$200,000 for the property), and the value of the property subsequently falls to \$180,000. If the taxpayer transfers the property to the lender in full satisfaction of the \$200,000 debt (assuming no reduction of principal), the taxpayer is treated as selling the house for the amount of the debt discharge (\$200,000). This produces no taxable event for the taxpayer ("sale" for \$200,000 and a basis of \$200,000 in the residence.) However, if gain does result because, for example, the basis of the property is \$150,000, n19 the gain may qualify for exclusion under *I.R.C. § 121*, which allows a single taxpayer to exclude up to \$250,000 of gain (\$500,000 for certain joint returns) on the sale of a principal residence, subject to certain limitations. However, if a loss results because, for example, the basis of the property is \$220,000, n20 the loss is not deductible because it is considered a personal loss. n21

Thus, regardless of whether a taxpayer is taking advantage of the HAMP program, is negotiating a debt modification with his or her lender, or is facing a foreclosure with either recourse or nonrecourse debt, there are several avenues available to eliminate phantom taxable gain for the homeowner.

Return to Text

n1 See www.makinghomeaffordable.gov.

n2 *I.R.C. § 61(a)(12)*.

n3 *I.R.C. § 108(a)(1)(A) - (E)*.

n4 See *Rev. Rul. 63-136, 1963-2 C.B. 19* (payments under the Manpower Development and Training Act); *Rev. Rul. 68-38, 1968-1 C.B. 446* (payments under the Economic Opportunity Act of 1964); *Rev. Rul. 74-205, 1974-1 C.B. 20* (payments under the Housing and Urban Development Act of 1968).

n5 *Rev. Rul. 2009-19, 2009-28 I.R.B. 111*.

n6 *I.R.C. § 61(a)(12)*.

n7 P.L. 100-142, amending *I.R.C. § 108*.

n8 Acquisition indebtedness is defined in *I.R.C. § 163(h)(3)(B)* as any indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, for purposes of the home mortgage interest deduction of *I.R.C. § 163(h)*, provided the debt is secured by the residence. Acquisition indebtedness will also include debt resulting from the refinancing of the original acquisition indebtedness, up to the amount of the refinanced debt.

n9 Principal residence has the same meaning for this purpose as under *I.R.C. § 121*. *I.R.C. § 108(h)(5)*. Note that the taxpayer can have only one principal residence. Thus, this exclusion will not apply to vacation or second homes, even though the taxpayer may be able to deduct the mortgage interest on the second home under *I.R.C. § 163(h)*.

n10 *I.R.C. § 108(h)(2)*.

n11 *Rev. Rul. 90-16, 1990-1 C.B. 12*. The "sale" portion may produce gain if the basis of the residence is less than the current value. For example, if the residence has a basis of \$100,000, assuming the \$200,000 mortgage was still acquisition debt, then the gain on the sale portion would be \$80,000. Although it would be rare for acquisition debt to exceed the basis of a residence, acquisition debt could exceed the basis of the property in certain circumstances, such as perhaps where the property basis has been depreciated as partly or formerly business property. Gain on the sale of a principal residence may be eligible for exclusion under *I.R.C. § 121*. Any loss on the sale portion (i.e., sale for \$180,000 - current value - when the basis of the property is \$220,000 - purchase price) is a non-deductible personal loss. *Treas. Reg. § 1.165-9*.

n12 *I.R.C. § 108(h)(4)*.

n13 H.R. Rep. No. 110-356. Where the taxpayer qualifies for more than one exclusion under § 108, certain ordering rules apply. See *I.R.C. § 108(a)(2)*. For example, the qualified principal residence exclusion will not apply if the taxpayer is in bankruptcy. *I.R.C. § 108(a)(2)(A)*.

n14 *I.R.C. § 108(a)(1)(E)*, as extended by P.L. 110-343, Sec. 303(a) Div A (the Emergency Economic Stabilization Act of 2008).

n15 *I.R.C. § 108(h)(3)*.

n16 *I.R.C. § 108(h)(1)*.

n17 *Rev. Rul. 91-31, 1991-1 C.B. 19*.

n18 See *Treas. Reg. § 1.1001-2(a)(2)*; *Rev. Rul. 90-16, 1990-1 C.B. 12*. As described above, a foreclosure with recourse debt is treated as a sale of the property for the fair market value of the property.

n19 As explained in footnote 11 above, it would be unusual for acquisition debt to exceed the basis of a residence.

n20 This would be a more common occurrence. For example, the taxpayer puts \$20,000 down, borrows \$200,000 of nonrecourse debt, and purchases a house for \$220,000. The value of the property then falls to \$180,000. A transfer to the lender in foreclosure is treated as a sale for the \$200,000 nonrecourse mortgage (assuming no reduction in principal), and the taxpayer has a \$20,000 loss ("sold" for \$200,000 with a basis of \$220,000). Although the taxpayer may feel as if he or she lost \$40,000 in value of the home, the taxpayer only economically lost his or her \$20,000 down payment, since this was a non-recourse loan, and the lender lost the other \$20,000.

n21 *Treas. Reg. § 1.165-9(a)*.

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16 of 79 DOCUMENTS

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Bernhardt on Kassir v. Zahabi

2009 Emerging Issues 4518

Professor Roger Bernhardt on Kassir v. Zahabi, 164 Cal. App. 4th 1352 (Cal. App. 4th Dist. 2008)

By Mr. Roger Bernhardt

October 29, 2009

SUMMARY: Get Emerging Issues Analysis on the California Court of Appeal decision in Kassir v. Zahabi, which found that the buyer of property was properly awarded rents in an action for specific performance.

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ARTICLE: This opinion justifies two inconsistent methods of calculating what credit a seller could receive for delayed receipt of the purchase price from the purchaser who has prevailed in a specific performance action brought against him or her. It is clear that the seller must not only transfer a title but must also account for the rents received during the delay period. However, it is not clear how much of a credit the seller should be given for his or her delayed receipt of the purchase price. In general, if a decree of specific performance is to put the parties as closely as possible in the situation that existed had they both performed on time, than both rental income and interest income should be factored into the final result.

On the one hand, in the penultimate paragraph of the opinion, the court states, with apparent approval, that an offset was properly granted for the interest the seller should receive. (However, since there was a delay of nearly three years on a price of \$480,000, it is difficult to understand how the amount is calculated at only \$14,000.)

On the other hand, in the immediately preceding paragraph, the court opines that there should be no offset for foregone interest at all because the property was overencumbered and nothing would have gone to the seller in any event. The logic of that statement is not apparent since a seller does remain liable for servicing the mortgages on his or her property until escrow has closed. (Even if the seller does not in fact pay those mortgages during that period, the consequences are that their balances will be larger at the time of closing and more funds must necessarily be diverted from what the seller will receive in order to deliver a marketable title to the purchaser.) It is likely that in this case the seller's very evasive behavior had something to do with the harshness of this conclusion.

Cross References:

■ California Forms of Pleading and Practice, Ch. 569, Vendor and Purchaser of Real Property, § 569.22 (Matthew Bender)

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California's Land Development Authority Impeded by Clean Air Act.

2009 Emerging Issues 4094

Alene Taber on Indirect Source Rules: The Regulation of Air Pollution or Land Use? Clean Air Act's State Implementation Plans' Impact on Local Regulation of Land Development

By Ms. Alene Taber

August 3, 2009

SUMMARY: While regulating state air quality, state implementation plans mandated under the federal Clean Air Act, restrict a state's ability to regulate land development. Land development when treated as an indirect source of emissions can be regulated like traditional air pollution sources. California's regulation of air quality through its use of indirect source rules restricts the authority of local jurisdictions to regulate land use.

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ARTICLE: Indirect Source Rules: The Regulation of Air Pollution or Land Use?

Land development is quickly becoming the choice *de jure* of California air pollution agencies seeking to reduce emissions. These agencies are looking to land development to be a new "mecca" of previously untapped emissions that can be regulated like traditional air pollution sources (e.g., smoke stacks, engines, and equipment) to achieve federal and state ambient air quality standards and reduce green house gas ("GHG") emissions.

Land development is considered by regulators to be an "indirect source" of emissions. An indirect source is any land use that generates or attracts vehicular activity that results in pollutant emissions. For example, a shopping center that attracts customers and employees to drive to the location would be considered an indirect source of emissions. Once deemed an indirect source, the shopping center is then targeted as being responsible for the vehicular emissions of the people that drive to work and shop at this particular location. Importantly, the local air district, or the developer, has no control over setting the vehicle "tail pipe" emissions and therefore has no direct control over the amount of emissions each vehicle emits as it travels to the shopping center. If this seems nonsensical -- it is in a way. The existence of a shopping center, or any other land use for that matter, exists for the purpose of attracting people to the location to live, work, use services, and purchase products, and yet the developer and operator may be required by air pollution regulators to find ways to reduce vehicle trips to these developments.

Overview of Federal and State Regulatory Authority

The federal Clean Air Act places primary responsibility for achieving the national ambient air quality standards ("NAAQS") on the states. 42 U.S.C. § 7407, subd. (a). Each state must adopt and submit for approval to the Environmental Protection Agency (the "EPA") a state implementation plan ("SIP") that specifies the measures pollution sources must take to achieve, maintain, and enforce the NAAQS. 42 U.S.C. § 7410, subd. (a)(1). Among other requirements, the SIP must include enforceable emission limitations, control measures, and timetables for compliance to achieve the NAAQS. 42 U.S.C. § 7410, subd. (a)(2).

In California, air pollution control is managed by the State through the California Air Resources Board ("CARB") and by local county air pollution control districts or regional air quality management districts. In general, the State has primary responsibility for the SIP, to establish State ambient air quality standards, and for air pollution control involving vehicular emissions and consumer products. Cal. Health & Safety Code, §§ 39002, 39602, 39606. Local air agencies have primary responsibility for air pollution control involving non-vehicle sources known as stationary sources (e.g., power plants, incinerators) and area sources (i.e., water heaters, fire places). Cal. Health & Safety Code, § 39002.

Land Development as an "Indirect Source" of Air Pollution.

Land development is simplistically categorized as a vehicular-related activity that can be controlled to reduce air pollutant emissions. Therefore, regulators have tended to approach regulating land development as a stationary source, requiring permits and requiring that developers implement a sufficient number of available control strategies to achieve specified emission reduction targets.

This treatment by regulators of land development as just another air pollution "source" begins with the federal Clean Air Act. The federal Clean Air Act identifies the availability of an "indirect source review program" to reduce emissions. Under the federal Clean Air Act, an indirect source review program means "the facility-by-facility review of indirect sources of air pollution, including such measures as are necessary to assure, or assist in assuring, that a new or modified indirect source will not attract mobile sources of air pollution, the emissions from which would cause or contribute to air pollution concentrations." 42 U.S.C. § 7410(a)(5)(A).

Originally, EPA required that all SIPs contain indirect source review regulations. *California Tahoe Regional Planning Agency v. Sahara Tahoe Corp.*, 504 F.Supp. 753, 766-767 (1980). However, significant controversy erupted in response to EPA's indirect source review requirement because it was viewed as a significant intrusion into a traditionally local domain -- land use. *Id.* at 767; see also *Manchester Environmental Coalition v. Environmental Protection Agency* 612 F.2d 56 (1979). A number of states opposed the requirement and eventually Congress restricted the funding for EPA's administration of the indirect source program forcing EPA to suspend indefinitely its requirement that SIPs include indirect source review programs. *California Tahoe Regional Planning Agency*, 504 F.Supp. at 767. In the 1977 amendments to the Clean Air Act, Congress also imposed strict limits on the Administrator's authority over indirect sources and allowed states to delete indirect source programs they had previously included in their SIPs. *Id.* Until indirect source programs were eliminated as a SIP requirement, a number of developers were sued in federal court regarding their indirect source permits. See, e.g., *California Tahoe Regional Planning Agency*, 504 F.Supp. at 768-769 (court noting the unfair position developer was in when the federal regulation requires an indirect source permit before building a parking garage, but Nevada state law bars a state agency from issuing such a permit); *City of Highland Park v. Train* 519 F.2d 681 (1975) (plaintiffs sought to compel EPA administrator to promulgate indirect source regulations to preclude construction of a shopping center and road extension and widening project) *Pinkney v. Ohio Environmental Protection Agency* (1974) 375 F.Supp. 305 (community residents sued state over the development of a shopping mall claiming that it will attract air pollution); *Citizens Association of Georgetown v. Washington* (1974) 370 F.Supp. 1101 (environmental group sued to apply the indirect source review program to the construction of buildings in a Georgetown waterfront area).

Under the federal Clean Air Act, a state may include an indirect source control measure in its SIP, but EPA may not require indirect source rules ("ISR") as a condition of approval of a SIP. 42 U.S.C. § 7410(a)(5)(A)(i). Once, however, a state submits an indirect source review program the EPA may approve and enforce it as part of an applicable

SIP. *Id.*; see also, e.g., *Bayview Hunters Point Cmty. Advocates v. Metro. Transp. Comm'n* (9th Cir. 2004) 366 F.3d 692, 701 (regarding the possibility that such programs may possibly also be enforced by citizens suits brought under the federal Clean Air Act).

Under California law, local air districts have the authority to adopt and implement regulations that reduce or mitigate emissions from indirect sources and to encourage or require the use of measures which reduce the number or length of vehicle trips. Cal. Health & Safety Code, § 40716. However, CARB cannot require as a condition of approval of an SIP any indirect source review program or other land use control measures. Cal. Health & Safety Code, § 40468. If the area is designated as nonattainment for air pollution, then the local air district is required to include indirect and area-wide source control programs in its attainment plans, but only to the extent necessary to achieve and maintain the state ambient air quality standards by the earliest practicable date and if such ISRs are appropriate after considering a number of factors identified in California Health and Safety Code, section 40913. n1 Cal. Health & Safety Code, §§ 40918 subd. (a)(4), 40919 subd. (a)(1).

An ISR may require an indirect source to reduce vehicular emissions only to the extent that the air district determines that the source contributes to air pollution by generating vehicle trips that would not otherwise occur. Cal. Health & Safety Code, § 40717.5 subd. (a)(1). The air district must make reasonable and feasible efforts to assign responsibility for existing and new vehicle trips in a manner that equitably distributes responsibility among indirect sources. *Id.* There are some statutory limits on an air district's authority to reduce emissions from indirect sources. For example, an air district may not impose a requirement on shopping centers to reduce vehicle trips, require parking charges or eliminate existing parking spaces. Cal. Health & Safety Code, § 40717.6 subd. (a).

However, land development as an emission source is much more complicated than described in the federal or State Clean Air Acts and requires regulators to know the answers to many complex questions such as: which land use policies will affect urban form; will the urban form change as anticipated as a result of the land use policy; will travel behavior be changed as a result of the land use policy; and will the changed travel behavior result in emission reductions? EPA guidance entitled, *Granting Air Quality Credit for Land Use Measures: Policy Options* (EPA420-P-99-028 dated September 1999), aptly describes the relationship of land use to vehicular emissions as follows:

policy/programs ---> changes in urban form ---> changes in travel ---> changes in emissions

Controlling indirect source emissions is further complicated by the fact that only the local government has the authority to effect changes to the land use (that is to decide which land uses will be permitted, where certain land uses can be located, and how dense the development can be). Therefore, air districts are dependant upon the cooperation of local government and developers to bring about changes in land use that will reduce air pollution.

Southern California Plans to Regulate Land Development to Reduce Air Pollution

In California, one of the largest air pollution control agencies that reigns over some of the most polluted urban areas in the United States -- the South Coast Air Quality Management District ("SCAQMD") -- is drafting an ISR known as Proposed Rule ("PR") 2301. (The SCAQMD is responsible for all Orange County and the urban portions of Los Angeles, Riverside and San Bernardino Counties in California.) According to the SCAQMD, PR 2301 is intended to mitigate emission growth from *new* residential, commercial, industrial and institutional development, and redevelopment projects. PR 2301 is the regulatory implementation of a control measure, Emission Growth Measure (EGM)-01, that the SCAQMD previously adopted in its 2007 Air Quality Management Plan ("AQMP") which is the local contribution to California's SIP. The SCAQMD committed to a modest amount of emission reductions pollutant in the AQMP to be achieved through PR 2301 -- 0.5 tons per day of VOC, 0.8 tons per day of NO_x and 0.5 tons per day of PM_{2.5}.

According to the SCAQMD, its authority to implement PR 2301 is twofold. First, the SCAQMD cites to authority in the Health and Safety Code that authorizes air districts to adopt rules to reduce or mitigate emissions from indirect

sources. Cal. Health & Safety Code § 40716(a)(1). Second, the SCAQMD cites to California Clean Air Act requirements for air districts in California to achieve and maintain state standards by the earliest practicable date and for extreme non-attainment areas to include "all feasible measures." Cal. Health and Safety Code §§ 40913, 40914, and 40920.5. Thus, the SCAQMD's rationale is that state law mandates that SCAQMD proceed with developing PR 2301 because the San Joaquin Unified Valley Air Pollution Control District (another large air district in California) previously adopted an ISR that was challenged and upheld in court, thus establishing a precedent for these ISRs that the SCAQMD must follow.

This is unusual in that the SCAQMD took a different position in *Coalition for Clean Air, Inc. v. South Coast Air Quality Mgmt. Dist.*, 1999 U.S. Dist. LEXIS 16106 (C.D. Cal. Aug. 27, 1999). The Coalition for Clean Air, and other environmental organizations, sued the SCAQMD when it failed to implement approximately 32 control measures in its 1994 SIP into binding rules and regulations. The SCAQMD justified its position claiming that as time went on the SCAQMD became convinced that certain of the measures provided for in the 1994 SIP were inappropriate. In particular, the SCAQMD objected to the ISRs that called for regulating or limiting vehicle trips to certain events centers, shopping centers, schools, and airports as "socially infeasible and not worth pursuing." *Id.*

The Potential for Certain ISRs to Interfere with Local Land Use Authority

The California Supreme Court in *Big Creek Lumber Co. v. County of Santa Cruz* 38 Cal.4th 1139, 1151-1152 (2006), explained that land use regulation in California is historically a function of local government under the grant of police power contained in article XI, section 7 of the California Constitution. The land use patterns for a city or county are established by the general plan. "Zoning" translates the general plan policies by dividing a community into areas in which only certain designated uses and densities of land are permitted by the legislative body. Zoning directs the types of land uses, density and locations where a community will grow. It is the Legislature's intent that state zoning laws "provide only a minimum of limitation in order that counties and cities may exercise the maximum degree of control over local zoning matters." *Big Creek Lumber Co.*, 38 Cal. 4th at 1151-1152 quoting Cal. Gov. Code § 65800.

The statutory scheme imposes a planning and zoning hierarchy that implies ISRs are not intended to lead, but rather to follow local land use legislative decisions. The hierarchy is best described in *Leshner Communications, Inc. v. City of Walnut Creek* 52 Cal.3d 531, 540 (1990) as follows: "The Planning and Zoning Law itself precludes consideration of a zoning ordinance which conflicts with a general plan as a pro tanto repeal or implied amendment of the general plan. The general plan stands. A zoning ordinance that is inconsistent with the general plan is invalid when passed [citations omitted] and one that was originally consistent but has become inconsistent must be brought into conformity with the general plan. [Citation omitted.] The Planning and Zoning Law does not contemplate that general plans will be amended to conform to zoning ordinances. The tail does not wag the dog. The general plan is the charter to which the ordinance must conform." Under this reasoning then, ISRs must conform to local land use plans and not vice versa.

Land use patterns and density are two among many factors evaluated to assess travel behavior which in turn is used to compute the amount of vehicle trips and vehicle miles traveled associated with development projects. *See, e.g.*, discussion regarding modeling in *Movement Against Destruction v. Trainor* 400 F.Supp. 533, 548-550 (1975). Therefore, to reduce emissions associated with vehicle trips and miles traveled, regulators seek changes in land use patterns -- that is contiguous development that supports and provides for multimodal access -- and not development patterns that result in isolated residential subdivisions located beyond existing service areas and that is wholly dependent on automobile access. EPA's 2001 *Guidance on Improving Air Quality Through Land Use Activities* (EPA420-R-01-001 (January 2001)) concludes that certain types of urban forms necessitate the use of personal cars and trucks for travel, for example when jobs and housing are far away from each other and mass transit is not available. EPA identifies the five characteristics of urban form that influence travel and air quality to be: (1) density; (2) land use mix; (3) transit accessibility; (4) pedestrian-environmental/urban design factors; and (5) regional patterns of development. EPA further identifies as urban forms that can be changed to improve air quality as including: (1) transit-oriented development; (2) infill development; (3) Brownfield redevelopment; (4) mixed-use development; (5)

neotraditional design/pedestrian-oriented development; (5) developing concentrated activity centers; (6) strengthening downtowns; and (7) jobs/housing balance. However, as EPA recognizes, the kinds of actions that are needed to implement these strategies are within local government's purview. Even so, ISRs are viewed by some air district regulators as a capable regulatory means of effecting land use patterns for the purpose of reducing vehicular emissions.

County air pollution control districts are in a unique position to regulate indirect sources because their decision making body for air pollution control can be the same decision making body for land use decisions. Cal. Health & Safety Code, § 401000. Therefore, county air pollution control districts can consciously make decisions about air quality in the context of their land use authority and ensure that their legislative land use plans are consistent with their air quality regulations. Unlike county air pollution control districts, multi-jurisdictional air quality management districts, such as the SCAQMD, whose decisions are made by boards independent from local land use authorities, lack authority to inherently balance local land use decisions when regulating indirect sources. *See, e.g.*, Cal. Health & Safety Code, §§ 40152, 40220 *et seq.*, 40320 *et seq.*, 40420 *et seq.*, 40600(c). The isolation of air quality decision makers from local land use decision making raises the possibility of ISR infringement on local land use control.

In the case of the PR 2301, the SCAQMD proposes to regulate development projects with "operational" (non-construction related) emissions of 2.0 tons per year of NO_x that are required to prepare either an Environmental Impact Report ("EIR"), Negative Declaration or Mitigated Negative Declaration pursuant to the California Environmental Quality Act ("CEQA") Cal. Pub. Res. Code, §§ 21000 *et seq.* Development projects meeting this criteria would be required to submit and obtain approval from the SCAQMD of a Compliance Plan. As part of the Compliance Plan, the applicant must quantify the emissions associated with the development project *and implement sufficient measures to achieve a yet to be identified required percent reduction in the development project's NO_x emissions.* In spite of the statutory prohibition preventing air districts from imposing requirements on shopping centers to reduce vehicle trips, require parking charges or eliminate existing parking spaces Cal. Health & Safety Code, § 40717.6 (a), shopping centers are not exempt in PR 2301, although transportation and transit projects and projects at airports and marine ports are exempted.

The SCAQMD further identifies a list of land use- and transportation-related emission reduction measures developers can use to achieve the emission reduction requirement of the Compliance Plan. Importantly, there are no less than eight measures aimed at land use including: (1) mixed use; (2) residential density; (3) Brownfield redevelopment; (4) infill development; (5) transit oriented development; and (6) smart growth design. These land use measures are similar to the urban forms EPA identified that can be changed to improve air quality. According to EPA's 1999 guidance on air quality credit for land use measures, these types of measures are intended to change the urban form by redistribution of population and employment growth and change the microscale urban design or land use mixing.

The federal and California Clean Air Acts prohibit air agencies from using ISRs to infringe on the existing authority of counties and cities to plan or control land use. 42 U.S.C. § 7431; Cal. Health & Safety Code, § 40716, subd. (b). The California Health and Safety Code, section 40414 specifically prohibits the SCAQMD from infringing on the existing authority of counties and cities to plan or control land use, and no provision of the California Clean Air Act shall be interpreted as providing or transferring new authority over such land use to the SCAQMD. As discussed above, with few exceptions, it is the counties and cities that decide which land uses are permitted in the jurisdiction, where the land uses will be located, and how dense the development will be. The key question is at what point does an ISR constitute an infringement on the authority of counties and cities to plan or control land use.

The place to start the inquiry is with the question: "Who really controls land use when local government approves a development project only to have the air district refuse to issue the development project an ISR permit or imposes requirements that render the development infeasible?" What if compliance with the ISR requires the development of a project that the local government or community does not want, for example, a project with increased density? Which agency's law trumps?

The air district cannot require a developer to implement a mixed use project or increase residential density when

the general plan and zoning does not permit it. The air district cannot require transportation agencies to locate transit lines in certain corridors and require local government to increase densities in these corridors to support transit oriented development. Therefore, can the air district withhold an ISR permit or penalize the developer by the imposition of fees when a local government's land use plan prevents implementation of land use related measures called for in an ISR? If the air district does withhold an ISR permit because the local government's land use plan does not permit implementation of the land use strategies called for in the ISR -- is this an unconstitutional taking? What about when it is the consumer market that does not support the types of development projects the air district believes are necessary? Should air districts be the governmental entity encouraging developers to make changes in land use patterns and densities even when it does not conflict with local general plans and zoning? Air districts are responsible for achieving NAAQS and are not in a position to consider all of the public health, safety and welfare considerations that influence comprehensive land use and zoning laws. Therefore, does the air district's influence on developers to implement a different land use pattern infringe on local authority to make land use decisions?

The control exerted by an ISR over land use does not have to be overt to infringe on local land use authority. For example, one indicator of whether PR 2301 will impermissibly infringe on local land use authority could be whether development projects can reasonably achieve the emission reduction targets eventually established without implementing the land use measures. If land use measures are required in order to avoid paying mitigation fees or to receive enough credits to obtain a permit, then land use is arguably being control by the air district. In construing ISRs the court may ascertain and give effect to the practical effect of the regulation. *See, e.g., Engine Manufacturers Association v. South Coast Air Quality Management District* 541 U.S. 246, 254-256 (2004).

Local governments have the legal authority to address hardships caused by the application of land use requirements. For example, local governments can grant variances when the strict application of the zoning ordinance deprives the property of privileges enjoyed by other property in the vicinity. Cal. Govt. Code, § 65906. The non-county air districts have no such authority. The statutory scheme for air districts includes the provisions of various hearing boards to provide variance relief to permittees from the harsh imposition of air district regulations. However, there is a fundamental difference between the variances from air districts versus cities or counties. A hearing board may grant a variance from an air quality regulation for a limited timeframe until the permittee can comply with the rule, whereas, a city or county variance essentially grants a permanent exception from complying with a local ordinance or rule. Importantly, in the context of an ISR, the air districts lacks authority to grant the type of relief that a developer may have otherwise be entitled to from the local government. Is this result a sufficient "infringement" on local land use authority?

Another important aspect of ISRs is that under California law they may only reduce vehicular emissions to the extent that the air district determines that the source generates vehicle trips that would not otherwise occur. Cal. Health & Safety Code, § 40717.5 (a)(1). Therefore, growth that is already planned for and accommodated in the regional plans and SIP is a complicating factor. If SIPs assume an increase in growth over time when establishing their control programs, then is development that subsequently occurs which is consistent with the already planned growth really generating vehicle trips that would not otherwise occur? If the air district disregards planned for growth, has it infringed on local land use control by imposing an impermissible requirement on development?

California law also requires in ISRs that the air district must make reasonable and feasible efforts to assign responsibility for existing and new vehicle trips in a manner that equitably distributes responsibility among indirect sources. *Id.* In other words, the law requires that there be an effort to proportion the impacts caused by the development with the burdens imposed by the ISR so that new development is not bearing the burdens of all development. In addition, as discussed above, if the growth in vehicle trips is accounted for in the SIP, then are the vehicle trips associated with even new development considered "new" vehicle trips under California Health & Safety Code, section 40717.5 (a)(1)? What about pass-by trips? The Institute of Transportation Engineers recognizes that not all of the trips ending up at a development are new trips added to the roadway system because of the development, but may instead be "pass-by" trips that are made by vehicles already traveling on the adjacent roadway that decide to enter the development as an intermediate stop on the way from another destination. Therefore, the Institute of Transportation Engineers

recognizes that that such vehicle trips are not necessarily be "generated" by the development and should be taken into account in determining the number of vehicle trips assumed to be generated by a development project. ISRs that do not account for these considerations impose additional burdens on new development. Does the imposition of these burdens constitute an impermissible infringement on land use control?

Time is another complicating factor for ISRs that seek to reduce emissions through changes in land use. On one hand, the emission benefits of changing land use policies is uncertain (because it depends on changing travel behavior) and a long term venture (because the implementation of land use patterns are only realized after sufficient development has occurred). On the other hand, the emission benefits of ISRs have a limited "life span" because the emission contributions of indirect sources are measured by the number and miles traveled by vehicles whose emissions are being reduced through the imposition of more stringent emission control standards. Therefore, the greatest vehicle emission benefit is in the short term. So, at what point does the declining benefit of ISRs constitute an impermissible infringement on land use control?

Conclusion

The utilization of ISRs to control emissions associated with land development is not necessarily a "mecca" of previously untapped emissions that can be easily regulated by non-county air districts. Whether the large scale reforming of land use patterns through ISRs can change travel behavior and reduce emissions remains to be seen. Even if ISRs can accomplish emission reductions, it remains to be seen how ISRs mandated by non-county air districts will work with local land use controls.

ISRs can be used to support the reduction of emissions through means other than the imposition of a land use controls through permitting processes. ISRs could support the development of vehicle fleets that are powered by alternative fuels or even encourage emission reductions related to land use changes through market-based incentives. EPA's 1999 guidance on air quality credit for land use measures identified a number of potential economic incentive programs related to land use such as providing rewards for sustainable development that have monetary value to developers. According to EPA's 1999 guidance on air quality credit for land use measures, these rewards could include tax breaks, grants, beneficial fee structures, density bonuses, relief from impact mitigation requirements, or a streamlined permitting process. Air districts can work with the local governments to find ways to take credit in the SIP for the implementation of sustainable development practices by local cities and counties rather than creating yet another development permitting process that could impermissible infringe on local land use authority.

[Return to Text](#)

n1 Some of the factors in Cal. Health & Safety Code, § 40913 that might be relevant to ISRs include: projected emission increases based on industrial, vehicular, or population growth; anticipated effectiveness of available and potential control measures; and a determination by the air district board that the plan is a cost-effective strategy to achieve attainment of the state standards by the earliest practicable date.

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Obtaining local agency approvals for development projects; and,

Litigating government agencies involving environmental and land use regulations, and permit approvals.

Prior to joining Jackson DeMarco Tidus & Peckenpaugh, Ms. Taber worked for the South Coast Air Quality Management District (SCAQMD) for twelve and half years. As a Senior Manager, she was responsible for managing the permitting and enforcement of certain facilities, overseeing the CEQA and socioeconomic analysis to support SCAQMD rulemaking activities, and managing the development of air quality rules. Ms. Taber has experience with trading markets (RECLAIM), indirect source regulations, and global warming issues. Ms. Taber also was a previous city planner with the Southern California Association of Governments (SCAG) and the City of Carson.

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18 of 79 DOCUMENTS

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Effects of Non-Judicial Foreclosure on Tenant-Occupied Property

2009 Emerging Issues 4088

The Effects of Non-Judicial Foreclosure on Tenant-Occupied Property in California

By Mr. Christopher Martz

July 30, 2009

SUMMARY: Recent legislation drastically alters the legal landscape following non-judicial-foreclosure on tenant-occupied property both in terms of whether a residential lease survives the foreclosure sale and the steps necessary to terminate an extinguished lease or tenancy. This article highlights these important legislative developments and exposes common pitfalls for tenants and property-owners alike.

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ARTICLE: INTRODUCTION

By some estimates, rent-paying tenants occupy up to one-third of the properties lost in the recent wave of foreclosures in California. In raw numbers, that means tens-of-thousands of tenants are in danger of losing their homes, despite having paid the rent each month. By the same token, parties purchasing properties at trustee sales will often find themselves in the role of unintentional landlord and, perhaps, forced to determine whether, and how, tenants may be lawfully evicted.

2009 legislation drastically alters the legal landscape following non-judicial-foreclosure on tenant-occupied property, both in terms of whether a residential lease survives the foreclosure sale and in terms of the steps necessary to terminate an extinguished lease or tenancy. This article highlights these important legislative developments and exposes common pitfalls for tenants and property-owners alike.

Generally Speaking, Non-Judicial Foreclosure Extinguishes Subordinate Interests in Property. General principles governing the priorities of interests in real property provide that non-judicial foreclosure automatically extinguishes all subordinate (or "junior") interests in the property, including lease interests [*see, e.g., Aviel v. Ng*, 161 Cal. App. 4th 809, 816, 74 Cal. Rptr. 3d 200 (Cal. App. 1st Dist. 2008)]. If a landlord and tenant enter into a lease agreement after the date on which the foreclosed mortgage or trust-deed gets recorded, the lease is subordinate and does not survive non-judicial foreclosure. On the other hand, barring an agreement to the contrary (for instance a subordination clause in the lease whereby a pre-existing lease becomes subordinate to a subsequent encumbrance), leases executed before the foreclosed encumbrance are senior and, therefore, survive foreclosure. However, material

amendments to senior leases will not survive [see, e.g., *R-Ranch Mkts. #2 v. Old Stone Bank*, 16 Cal. App. 4th 1323, 1327-1329, 21 Cal. Rptr. 2d 21 (Cal. App. 4th Dist. 1993)].

Practitioners are warned that 2009 legislation significantly alters these general rules of priority in the residential context. Reliance on common-law principles governing the priority of liens may lead landlords, and their attorneys, to run afoul of the law.

Residential Lease Survives Non-Judicial Foreclosure for Remainder of Its Term. The "Protecting Tenants at Foreclosure Act of 2009" (PTFA) provides that an unexpired residential lease will survive foreclosure for whatever amount of time remains on the lease [Pub. L. No. 111- 22, § 702(a) (2009)]. Tenants who enter into a fixed-term lease before the notice of foreclosure are now entitled to remain in possession for the remainder of the lease term provided the lease meets the three-pronged test to qualify as bona fide. A lease is bona fide under PTFA if [Pub. L. No. 111- 22, § 702(b) (2009)]:

- The tenant is not the mortgagor or the mortgagor's child, spouse, or parent;
- The lease is the result of an arms-length transaction; and
- The rent due under the lease is not substantially less than market rent, unless the rent is reduced by a subsidy.

The protections of PTFA extend to subsidized tenancies as well. In such cases, the immediate successor in interest following non-judicial foreclosure takes the property subject to both of the following [Pub. L. No. 111- 22, § 703 (2009)]:

- The lease with the tenant; and
- The Housing Assistance Payment (HAP) contract with the local housing authority.

For both subsidized and non-subsidized properties, PTFA allows an exception for purchasers intending to occupy the unit as their primary residence. Such purchasers may terminate an unexpired lease with a 90-day notice. The details of the notice period mandated by the federal law are discussed below. The PTFA does not preempt other regulations in the field. Thus, a state or local law may provide greater protections to post-foreclosure tenants.

The PTFA expires automatically on December 31, 2012.

Local Ordinances May Preserve Tenancies Even When No Lease Entitles the Tenant to Possession. Even when PTFA does not apply because, for example, the lease is not bona fide or the tenancy is periodic, local eviction control ordinances may preserve a tenant's right to retain possession following foreclosure. Purchasers who take title to a tenant-occupied property are bound by applicable local eviction control ordinances even if the foreclosed encumbrance predates the ordinance itself [*Gross v. Superior Court*, 171 Cal. App. 3d 265, 217 Cal. Rptr. 284 (Cal. App. 1st Dist. 1985); *People v. Little*, 143 Cal. App. 3d Supp. 14, 192 Cal. Rptr. 619 (Cal. App. Dep't Super. Ct. 1983)]. The typical eviction control ordinance in California enumerates certain "just-causes" which allow termination of a tenancy. For the most part, sale of the property through foreclosure is not one of these just-causes. Cal. Code Civ. Proc. § 1161a(b)(2), which provides for summary eviction of holdover tenants after foreclosure, does not preempt these local eviction controls [*Gross v. Superior Court*, 171 Cal. App. 3d 265, 269-272, 217 Cal. Rptr. 284 (Cal. App. 1st Dist. 1985)].

In response to the scope of the foreclosure crisis, some jurisdictions, even those without pre-existing eviction control systems, have enacted new ordinances speaking directly to the rights of tenants and owners taking through foreclosure. Given the frequency with which new legislative responses appear to this issue, best practices dictate that counsel for both landlords and tenants conduct a thorough review of the most recent activity in their jurisdictions before advising clients.

Rent Increases After Foreclosure Must Comply With Local Rent Control Ordinances. In the same way that a local eviction control ordinance binds successor owners taking through non-judicial foreclosure, local rent control ordinances continue to govern after foreclosure. Thus, in a jurisdiction with applicable rent controls, the successor owner may only raise rents in keeping with the terms of those controls [*People v. Little*, 143 Cal. App. 3d Supp. 14, 19-20, 192 Cal. Rptr. 619 (Cal. App. Dep't Super. Ct. 1983)].

Landlords Must Give Extended Notice to Tenants to Terminate Tenancy Following Non-Judicial Foreclosure. Under the PTFA, as of May 20, 2009, immediate successors in interest taking through non-judicial foreclosure must provide a 90-day notice to terminate a bona fide tenancy [Pub. L. No. 111-22, § 702(a)(1) (2009)]. A tenancy is bona fide under PTFA if it meets the three-part test discussed above. Again, PTFA does not preempt other notice laws. Thus, state or local legislation may mandate even longer notice periods. Practitioners should carefully consult the newest local laws as certain California jurisdictions require additional notice. As previously noted, PTFA expires automatically on December 31, 2012. In cases where PTFA does not provide the notice period, Cal. Code Civ. Proc. § 1161b mandates a 60-day notice to terminate a tenancy following foreclosure unless the tenant remaining in possession was a party to the foreclosed encumbrance [Cal. Code Civ. Proc. § 1161b(a), (b)]. Section 1161b expires on January 1, 2013 [Cal. Code Civ. Proc. § 1161b(c)].

Unlawful Detainer Actions Following Non-Judicial Foreclosure Include Additional Elements. Cal. Code Civ. Proc. § 1161a allows for the summary eviction of tenants holding over after a foreclosure sale. However, plaintiffs should note that successfully prosecuting an unlawful detainer following non-judicial foreclosure involves additional pleading and proof requirements. Plaintiff must plead and prove that the foreclosure sale complied with the requirements of Cal. Civ. Code § 2924 and that the plaintiff subsequently perfected title. Contrary to the general rule that issues of title are not properly part of an unlawful detainer action, the defendant in an action brought under Code Civ. Proc. § 1161a may litigate plaintiff's title to the extent of challenging the propriety of the foreclosure sale and subsequent perfection of title [See, e.g., *Vella v. Hudgins*, 20 Cal. 3d 251, 255, 572 P.2d 28, 142 Cal. Rptr. 414 (Cal. 1977); *Stephens v. Hollis*, 196 Cal. App. 3d 948, 953, 242 Cal. Rptr. 251 (Cal. App. 3d Dist. 1987); *Cal. Livestock Prod. Credit Ass'n v. Sutfin*, 165 Cal. App. 3d 136, 140 n.2, 211 Cal. Rptr. 152 (Cal. App. 3d Dist. 1985); *Evans v. Superior Court*, 67 Cal. App. 3d 162, 169, 136 Cal. Rptr. 596, 136 Cal. Rptr. 596 (Cal. App. 2d Dist. 1977)]. Defendants in an unlawful detainer action brought under Code Civ. Proc. § 1161a by a successor owner should note that the defense of retaliatory eviction is not available [Cal. Livestock Prod. Credit Ass'n v. Sutfin, 165 Cal. App. 3d 136, 142-143, 211 Cal. Rptr. 152 (Cal. App. 3d Dist. 1985)]. The California Judicial Council Form complaint for unlawful detainer [JC Form UD-100] may not be used in a proceeding for eviction after foreclosure.

CONCLUSION

Counsel representing successor owners or tenants of foreclosed property should closely follow developments at the federal, state, and local level as the landscape surrounding this issue continues to evolve. In response to the steep upswing in rates of foreclosures, additional jurisdictions may well enact legislative responses governing the relationship between tenants and successor owners of foreclosed properties.

CROSS REFERENCES:

For additional coverage on the effects of non-judicial foreclosure on the landlord-tenant relationship, see:

- California Real Estate Law & Practice, Ch. 200A, *Effect of Non-Judicial Foreclosure on the Landlord-Tenant Relationship* (LexisNexis Matthew Bender) (scheduled for publication in October 2009).
- Matthew Bender Practice Guide: California Landlord-Tenant Litigation

For complete coverage of the effect of local rent and eviction controls, see:

- California Real Estate Law & Practice, Ch. 171, *Rent and Rent Control* (LexisNexis Matthew Bender).
- Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 8, *Local Rent and Eviction Controls*.
- California Forms of Pleading and Practice, Ch. 335, *Landlord and Tenant: Rent Control* (LexisNexis Matthew Bender).

For discussion of the law and procedure of non-judicial foreclosure, see California Real Estate Law & Practice, Ch. 123, *Nonjudicial Foreclosure* (LexisNexis Matthew Bender).

For coverage of subordination agreements and commercial lease drafting, see California Real Estate Law & Practice, Ch. 153, *Drafting Commercial Leases* (LexisNexis Matthew Bender).

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19 of 79 DOCUMENTS

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Professor Roger Bernhardt on Witt Home Ranch v. County of Sonoma

2009 Emerging Issues 3985

Professor Roger Bernhardt on Witt Home Ranch, Inc. v. County of Sonoma, 165 Cal. App. 4th 543 (Cal. App. 1st Dist. 2008)

By Roger Bernhardt

July 8, 2009

SUMMARY: Get Emerging Issues Analysis on the CA decision in Witt Home Ranch. Here, the court found that parcels depicted on a map recorded in 1909 under the subdivision law then in effect did not come within the scope of the Subdivision Map Act grandfather clause. A local agency may deny an application for a certificate of compliance where the effect of issuing a certificate would be to effectively subdivide the property without complying with the Act.

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ARTICLE: This decision officially holds that subdivision maps recorded before 1915 are not grandfathered in by in Cal. Gov. Code § 66499.30(d), because even though there was a Subdivision Map Act then in existence, it did not yet regulate the design and improvement of subdivisions. Since no such statutory regulation came into effect until 1929, an inevitable effect of the decision is to eliminate the protection of the exemption for the 1915-1929 period as well. When combined with the 2003 Supreme Court decision in *Gardner v. County of Sonoma*, 29 Cal. 4th 990 (Cal. 2003), the overall effect is that all subdivision maps filed before 1929, and not executed upon, are probably ineffective. Developers will need to file new maps and must therefore now comply with the latest version of the local ordinance.

However, there are two caveats:

- Although this decision has statewide effect, it is not clear that all other appellate courts will agree with it. To justify its conclusion, these judges had to both (a) reject the opinion of the attorney general that all previously recorded maps were exempt, and (b) reject the opinion of both the attorney general and the office of legislative counsel that the 1943 revisions to the Subdivision Map Act (which added the more restrictive "design and improvement" provision to the exemption) did not change the substance of the earlier blanket exemption. Those contrary administrative opinions can readily support a different conclusion by a different panel of judges.
- There was no claim of any vested right by this developer; this land had remained intact for the entire 90 years that had passed since the subdivision map had been filed. Since the court stressed this fact (although it did not say how much could have been attempted in the absence of a certificate of compliance), that feature also may give those who see the issue differently a basis on which to reach a different conclusion under a different set of facts.

RELATED LINKS: For additional coverage, see

- Manaster & Selmi, California Environmental Law & Land Use Practice, Ch. 61, Subdivision Regulation, § 61.03 (Matthew Bender);
- California Real Estate Law & Practice, Part 4, Division 4, Ch. 292, Procedural Requirements of the Subdivision Map Act, § 292.09 (Matthew Bender);
- California Forms of Pleading & Practice, Ch. 579, Zoning and Planning, § 579.279 (Matthew Bender)

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20 of 79 DOCUMENTS

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Professor Roger Bernhardt on Baychester Shopping Center

2009 Emerging Issues 3957

Professor Roger Bernhardt on Baychester Shopping Center, Inc. v. San Francisco Residential Rent Stabilization & Arbitration Bd., 165 Cal. App. 4th 1000 (Cal. App. 1st Dist. 2008)

By Roger Bernhardt

July 1, 2009

SUMMARY: Get Emerging Issues Analysis on the California Court of Appeal decision in Baychester Shopping Center, where a successor landlord was found liable for refunding the overpayment of rent charged by its predecessor to a tenant under the San Francisco Residential Rent Stabilization and Arbitration Ordinance.

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ARTICLE: The publication of this decision should serve as a warning to all purchasers of residential rental properties of a potential exposure to liability that they must guard against.

Although the decision turns on the particular language of the San Francisco residential rent control ordinance, it is likely that similar provisions exist in other local measures and/or will soon become part of those measures. Municipal governments appreciate the effect of this decision.

Although it was also true that this particular rent overcharge could have been discovered by the purchaser ahead of time, since the tenant's petition to the rent board had been filed before the close of escrow, nothing in the holding turns on that fact, and this landlord could not have been held liable for the refund on overcharged rent based on a petition filed several years after the purchase had been completed. Its liability was strict, and neither fault nor knowledge played any role.

As far as the purchaser's relation with the vendor is concerned, liability or potential prospective rent rebates should be covered in the contract of sale, probably in the initial offer. It is likely that a purchaser can recover indemnification for rents it had to pay that had been collected by its predecessor in any event, but an indemnification clause reduces uncertainty on the issue and can elaborate on appropriate details. However, since the rent refund claim can arise several years later, the purchaser may also need a mechanism that can ensure liquidity at a later time.

More important is for the purchaser to ensure against any possibility of this claim appearing at all. Since, as has been noted, a claim for a refund need not have been filed by the close of escrow in order to be valid against the

purchaser, due diligence now requires that the purchaser be as certain as possible that no such claims ever will arise. Estoppel letters to all residential tenants (including, perhaps, even former ones) should specifically include the question of the legitimacy of their rents and ambiguous responses (and certainly non-responses) must be followed up thoroughly. Counsel for purchasers should make sure that their brokers are doing all they can to reduce this risk.

Petition for review of the appellate court decision was denied by the California Supreme Court in *Baychester Shopping Center, Inc. v. San Francisco Residential Rent Stabilization & Arbitration Board/(Fingerhut)*, 2008 Cal. LEXIS 12619 (Cal. Oct. 16, 2008).

RELATED LINKS: For additional coverage, see

- Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 8, Local Rent and Eviction Controls;
- California Real Estate Law & Practice, Ch. 171, Rent and Rent Control, § 171.40 (Matthew Bender);
- California Forms of Pleading & Practice, Ch. 335, Landlord and Tenant: Rent Control, § 335.12 (Matthew Bender)

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John V. Orth on Estate of Johnson

2009 Emerging Issues 3491

John V. Orth on Severing Joint Tenancy--Estate of Johnson

By John V. Orth

March 30, 2009

SUMMARY: Amateur estate planning goes awry and the doctrine of four unities is abandoned. In this Emerging Issues Analysis, Professor John V. Orth describes a family's attempt to sever a joint tenancy with right of survivorship and analyzes the "intent-based approach" for recognizing a joint tenancy's existence.

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ARTICLE: Amateur estate planning goes awry.

Husband and wife held property as joint tenants with right of survivorship. When the wife became seriously ill, the family prevailed upon her in her hospital room to execute a power of attorney allowing them to retitle the property in the husband's sole name. This they attempted to do by having the husband and the wife's attorney-in-fact execute a quitclaim deed from the couple to the husband alone. Confounding the family's expectations, the husband predeceased his wife. The wife (or those acting on her behalf) alleged that she was incompetent at the time she executed the power of attorney and claimed all the property by right of survivorship. The trial court agreed that the power of attorney was invalid, but held that the effect of the husband's participation in the grant to himself as sole owner at least had the effect of severing the joint tenancy, converting it into a tenancy in common. In consequence, the husband's estate was entitled to a one-half interest in the property. The Iowa Supreme Court reversed on the issue of severance, holding that the deed was intended to transfer the entire estate to the husband and was void. On her husband's death, the wife therefore became sole owner by right of survivorship.

The Doctrine of the Four Unities.

Understanding the issue in this case requires a quick review of basic property law. The creation and continuance of a common law joint tenancy, which included the so-called right of survivorship, required that the interests of the joint owners share four unities: time, title, interest, and possession. That is, their interests had to commence at the same time, derive from the same title, be the same type of interest, and give the same undivided right of possession. As a necessary consequence, a conveyance by a sole owner to himself and another could not at common law create a joint tenancy, even if that had been its intended effect. To create a joint tenancy in such a case required the use of a so-called straw-party conveyance, that is, a conveyance from the sole owner to a third party (the straw man), who then re-conveyed to the two as joint tenants. This requirement has been eliminated by statute in a majority of states. *See 4*

Thompson on Real Property, Second Thomas Edition (David A. Thomas ed.) § 31.06(c) (LexisNexis) (summarizing statutes).

Just as the four unities were required to create a joint tenancy at common law, so the elimination of any one of the unities terminated a joint tenancy. If one joint tenant conveyed his share to a third party, three of the four unities (time, title, and interest) were destroyed, and the third party took the share as tenant in common. But if a joint tenant executed a conveyance directly from himself to himself, it was ineffective at common law to sever the joint estate because the four unities remained intact. At common law a conveyance from oneself to oneself was of no effect. The grantors interest was just what it had been to begin with. Here too a straw party conveyance was necessary. Usually the statutes allowing direct conveyance from a sole owner to himself and another as joint tenants also allow, either expressly or by implication, a direct conveyance from a joint tenant to himself as tenant in common.

The Four Unities or the intent of the parties?

The Iowa Supreme Court used the present case as the occasion to announce the abandonment of the doctrine of the four unities to create and maintain a joint tenancy. Henceforth, the state would join others in following an intent-based approach for recognizing the existence of a joint tenancy. *See 739 N.W.2d 493, 497 (Iowa 2007)*. The problem in this case, then, was determining the intent. It was argued on behalf of the husbands estate that his intent to change the nature of the tenancy was clear, and although without his wifes joinder he could not transfer the entire estate to himself, his action in executing the deed was effective to sever his interest in the joint tenancy and convert it into an interest in tenancy in common.

While accepting that a direct conveyance from himself as joint tenant to himself as tenant in common impossible at common law under the rule of the four unities would have been effective under the new intent test, the Court held that the husbands intent in this case, as gathered from the deed, was not to sever his interest from his wifes, but to terminate the joint tenancy and secure the entire estate for himself. Although the Court abandoned the potentially intent-defeating rule of the four unities, it admitted that intent alone was not enough under the new test. There must also be some action or instrument sufficient to corroborate and give effect to that intent. *See 739 N.W.2d 493, 499 (Iowa 2007)*. Without it, the intent to sever would still be defeated.

While extrinsic evidence may support the Courts finding of the husbands true intention, the deed in question was a quitclaim rather than a warranty deed, so contained no recitals concerning the grantors title or intention. It simply recited that the husband and wife quitclaimed to the husband all our right, title, interest, estate, claim and demand. *See 739 N.W.2d 493, 495 (Iowa 2007)*. One must wonder whether the Court would have reached the same result if the quitclaim had been from the husband and the wifes attorney-in-fact to a third party. Since the power of attorney was invalid, the wife did not effectively convey her interest, but it might well be held in that case that the husband effectively conveyed his interest, leaving the third party and the wife as tenants in common.

Medicaid recovery?

The Court recognized in a footnote that the family might have been trying to help the wife qualify for Medicaid, although the decisions were likely based on erroneous assumptions. *See 739 N.W.2d 493, 494 n. 2 (Iowa 2007)*. It is hard to avoid the suspicion that the Court too was concerned about Medicaid. Failure to find a severance meant that the surviving wife had assets available to pay the cost of her care.

The federal Deficit Reduction Act of 2006 requires that states implement asset recovery programs, and many states, including Iowa, now have statutes that define the estate of a medical assistance recipient to include interests in jointly held property. The necessary implication of such statutes is that joint tenancies are severed, at least to the extent necessary to repay the Medicaid program. *See In re Estate of Serovy, 711 N.W.2d 290 (Iowa 2006)*. If the joint tenancy in the present case had remained intact and the wife had predeceased the husband, the joint tenancy would have been severed by operation of law.

What action or instrument will effect a severance?

Although the justices of the Iowa Supreme Court recognized that a direct conveyance from a joint tenant to a third party, or even from a joint tenant to himself, would be effective to sever the joint tenancy, they did not indicate what other actions or instruments would have that effect. It is unlikely that they meant to abandon the rule that a joint tenancy may not be severed by will, even if the intention to sever is clearly expressed. As the Court acknowledged in the very first sentence of its opinion, The right of survivorship makes joint tenancies a popular form of property ownership. *Id.* 495. The principal reason for this popularity is that the right of survivorship operates independently of probate. To preserve this advantage, the possibility of severance by will must be denied. Perhaps the Court addressed this by saying that the new rule required, in place of the formal requirement of the four unities, a formal requirement that there be an action or instrument sufficient to corroborate and give effect to that intent. *Id.* 499. But that begs the question whether the will is such an instrument. A will is not effective to sever a joint tenancy only so long as the courts say it is not.

At about the time the Iowa Supreme Court was abandoning the doctrine of the four unities, the Supreme Court of the neighboring state of Nebraska was reaffirming it, holding that even a notarized and recorded notice of severance was ineffective to sever a joint tenancy regardless of intent because it did not eliminate any one of the four unities. *In re Estate of Potthoff*, 733 N.W.2d 860 (Neb. 2007). It is uncertain whether the Iowa court would accept such an instrument as sufficient to corroborate and give effect to that intent.

Likewise, courts in other states continue to hold that a judicial partition is effective only on the date of the final decree, not on the filing of the petition, despite the fact that the filing itself is clear evidence of the intent to sever. *See, e.g., Rusnak v. Phebus*, 2008 Tenn. App. LEXIS 328 (matter of first impression in Tenn.); *Mercurio v. Headrick*, 983 So. 2d 773 (Fla. App. 2008) (matter of first impression in Fla.). Under the doctrine of the four unities, this result is explained by the fact that the filing does not destroy any of the unities, while the final decree of partition obviously does. Under the intent test if the result is to be the same the explanation must be that the filing is not an action or instrument sufficient to corroborate and give effect to that intent. But again this is so only if the courts say it is so.

RELATED LINKS: For additional discussion of joint tenancy, see

- Powell on Real Property Ch. 51, Joint Tenancy (Michael Allan Wolf ed., LexisNexis Matthew Bender).

ABOUT THE AUTHOR(S):

John V. Orth is William Rand Kenan, Jr. Professor of Law at the University of North Carolina at Chapel Hill, where he has taught for 30 years. He is the recipient of the University's award for excellence in teaching. His undergraduate degree is from Oberlin College, and he has a law degree and Ph.D. in history from Harvard University. He contributes the chapters on concurrent estates to *Thompson on Real Property, Thomas Edition*, as well as annual articles in the series Reappraisals in the Law of Property, published in *The Green Bag*. He is the author of *How Many Judges Does It Take to Make a Supreme Court, and Other Essays on Law and the Constitution* (2006); *Due Process of Law: A Brief History* (2003); *The North Carolina State Constitution with History and Commentary* (1993); *Combination and Conspiracy: The Legal History of Trade Unionism, 1721-1906* (1991); and *The Judicial Power of the United States: The Eleventh Amendment in American History* (1987). Professor Orth has published numerous law review articles on constitutional law, property law, and legal history. His publications have been cited by federal and state courts, including the United States Supreme Court and the North Carolina Supreme Court.

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John V. Orth on Sylva Shops Ltd. Partnership v. Hibbard, 623 S.E.2d 785

2009 Emerging Issues 3469

John V. Orth on Waiver of a Landlord's Duty to Mitigate in Sylva Shops Ltd. Partnership v. Hibbard, 623 S.E.2d 785

By John V. Orth

March 20, 2009

SUMMARY: Professor John V. Orth explains how this case on a commercial tenants waiver of the landlords Duty to Mitigate evidences the ongoing division of the law of landlord and tenant into residential and commercial categories and why a lease is not quite like any other contract.

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ARTICLE: Bagel Bin goes bust.

Defendants leased space in plaintiffs shopping center for a term of five years, for the purpose of operating the Bagel Bin. Despite a promising beginning, when summer came and the local college students left, the business failed, and defendants abandoned the premises. Plaintiff made some effort to find a replacement tenant but refused to reduce the rent below that originally agreed to by the defendants, and months passed before a new tenant was found. Plaintiff sued for unpaid rent and relied on a lease provision that Landlord shall have no obligations to mitigate Tenants damages by reletting the Demised Premises. Holding the proviso invalid, the Superior Court judge ordered a trial to determine the amount of rent plaintiff would have received by proper acts in mitigation and offset plaintiffs damages by that amount. On appeal, the North Carolina Court of Appeals reversed, holding the defendants liable for the entire amount, without offset.

Landlords duty to mitigate.

The trend in the law of landlord and tenant is toward the adoption from contract law of the so-called duty to mitigate damages. See Stephanie G. Flynn, *Duty to Mitigate Damages Upon a Tenants Abandonment*, 34 Real Property, Probate & Trust J. 721 (2000). No real duty is involved; rather, the plaintiff is not allowed to recover damages from the defendant to the extent that plaintiff could have reduced the loss by appropriate action. As applied to leases, the duty raises difficult questions when the lease to the replacement tenant is for a different term or at a different rent. Although the latest Restatement of the Law of Landlord and Tenant does not itself require mitigation, it takes the position that the landlord may, after notification to the tenant, attempt to relet the premises for the tenants benefit and that a reletting may be for the benefit of the tenant even though it is for a term shorter or longer than the term in the original lease, and even though it is for a rent lesser or greater than the rent reserved in the original lease. *Restatement (2d) of Prop.: Landlord & Tenant* § 12.1, cmt i.

Although the instant case included issues of whether the landlord had been diligent enough in seeking a replacement tenant and particularly whether the landlord was required in these circumstances to accept a lesser rent in mitigation of defendant's damages, the appellate court avoided these issues by deciding that the landlord had no duty to mitigate at all because the tenant had effectively waived the duty by lease provision. Waiver of the duty to mitigate is a relatively recent development, and courts' reactions are mixed. The North Carolina court cited cases from Arkansas, New York, and Ohio allowing waiver, but recognized that New Jersey by judicial decision and Texas by statute make the duty non-waivable.

Leases: like any other contract.

The North Carolina Court of Appeals began its analysis by categorizing a lease as a contract and quoting an earlier state Supreme Court opinion that it is the simple law of contracts that as a man consents to bind himself, so shall he be bound. *Troitino v. Goodman*, 35 S.E.2d 277, 283 (1945). It then acknowledged that North Carolina has adopted the requirement of mitigation in all leases, commercial as well as residential. Nonetheless, reverting to the principle of freedom of contract, the court held that it was not contrary to public policy to allow parties to contract away that duty in commercial leases, analogizing it to a contract exculpating a person from the results of ordinary negligence.

Defendants in this case did not argue that the provision against mitigation was the product of unequal bargaining power, but the court clearly would not have been too receptive to that argument in any event, observing that in commercial leases there is relatively equal bargaining power due to the availability of other space and the fact that neither party is compelled to make a deal. 623 S.E.2d at 791. Nor did the court find it relevant that the lease also included a covenant against tenant transfer by assignment or subleasing without prior written consent, which consent could be withheld in the landlord's sole discretion.

The case evidences the ongoing division of the law of landlord and tenant into residential and commercial categories. It also demonstrates that the oft-repeated notion that a lease is like any other contract is overly broad. While contract law does allow the general duty to mitigate to be replaced by a stipulation of reasonable liquidated damages so long as it is not in fact a penalty it does not allow the total waiver of the duty.

Drafting lesson.

The obvious lesson for lawyers drafting commercial real estate leases is to consider the advisability of including a clause relieving the landlord of the duty to mitigate damages. At least in North Carolina such waivers are presumptively valid until and unless the state Supreme Court addresses the issue. See *Kotis Properties, Inc. v. Caseys, Inc.*, 645 S.E.2d 138 (N.C. App. 2007) (affirming summary judgment in favor of landlord where abandoning tenant had waived duty to mitigate).

RELATED LINKS: For additional discussion about Landlord Rights When the Tenant Abandons the Premises, see
 ■ 5 Thompson on Real Property, Second Thomas Edition § 40.11 (David A. Thomas, N. Gregory Smith, eds. LexisNexis).

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United States: The Eleventh Amendment in American History (1987). Professor Orth has published numerous law review articles on constitutional law, property law, and legal history. His publications have been cited by federal and state courts, including the United States Supreme Court and the North Carolina Supreme Court.

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23 of 79 DOCUMENTS

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John V. Orth on Walters v. Leech

2009 Emerging Issues 3470

John V. Orth on Walters v. Leech, 279 Mich. App. 707--Child Support Versus Tenancy by the Entirety

By John V. Orth

March 20, 2009

SUMMARY: In this Emerging Issues Analysis on Walters v. Leach, Professor John V. Orth explores the refusal by the Michigan Court of Appeals to extend *United States v. Craft*, 535 U.S. 274 (2002) to impose a lien for overdue child support against a house held in tenancy by the entirety.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Child support versus Tenancy by the entirety.

The mother of a minor child owed the father, who had physical custody, almost \$45,000 in overdue child support. The County Friend of Court sought a child support lien against a house held in tenancy by the entirety by the mother and her present husband, where they lived with their three children. A family court referee signed the proposed order, but the mother objected and the trial court refused to impose the lien. Although a Michigan statute provides that overdue child support constitutes a lien against the real and personal property of a payer, the Court of Appeals affirmed the trial courts denial of the lien. It refused to extend *United States v. Craft*, 535 U.S. 274 (2002), the U.S. Supreme Court case which held that, for purposes of federal law, a Michigan tax debtor had a separate interest in property he held with his wife in tenancy by the entirety. Instead, the Michigan Court of Appeals reaffirmed the states adherence to the established common law rules that property held in tenancy by the entirety is the property of both spouses together and that neither spouse has a separate interest in the property.

Statutory construction.

The Court of Appeals began its analysis of the Michigan statute by quoting caselaw repeating a long-standing canon of statutory construction: Statutes in derogation of the common law must be strictly construed, and will not be extended by implication to abrogate established rules of common law. *Nation v. WDE Electric Co.*, 563 N.W.2d 233, 236 (Mich. 1997) (quoting a prior case). The court next recited the common law rules concerning tenancy by the entirety. The estate is available only to married couples, who are considered one person in law. On the death of one spouse, the other is the sole owner of the estate by right of survivorship. Neither spouse has an individual interest in the property, so neither spouse can alienate or encumber it without the other. In consequence, for purposes of collecting overdue child support from the mother in this case, the house she holds with her present husband in tenancy by the entirety is not the property of a payer.

No consideration was given to the source of funds used to purchase the house on which the lien was sought to be imposed. Had the mother used her own funds to contribute to its purchase instead of paying her child support, an issue of fraudulent transfer would have arisen. As the court recognized, Michigan law holds that tenancies by the entirety cannot be created to defraud creditors. 279 Mich. App. 707, 711 n. 1.

***Craft* left high and dry.**

Complicating the otherwise straight-forward statutory construction is the fact that the U.S. Supreme Court in *Craft* had construed a federal tax lien statute that applied to all property and rights to property to cover the individual share of property that a Michigan tax debtor held with his spouse in tenancy by the entirety. The Supreme Court listed the extensive rights to use and enjoyment that Michigan law recognized in each spouse, 535 U.S. at 282, and concluded that the fact that the husband could not unilaterally alienate the property does not preclude him from possessing property and rights to property for purposes of federal law. *Id.* 285. The decision in *Craft* had originally caused some alarm that the traditional protection against the claims of creditors afforded by the estate would be lost. *But see* Steve R. Johnson, *Why Craft Isn't Scary*, 37 *Real Property, Probate & Trust Journal* 440 (2002).

Although the Michigan Court of Appeals made some effort to distinguish the state statute on the ground that, unlike the federal statute, it did not refer to the child support debtors *rights to* property but only to the property of a payer, the real difference must be that after *Craft* there are distinct federal and state definitions of property in Michigan (and states like it) that continue to recognize traditional tenancies by the entirety. For a list of 16 such states, see Steve R. Johnson, *After Drye: The Likely Attachment of the Federal Tax Lien to Tenancy-by-the-Entireties Interests*, 75 *Ind. L.J.* 1163 (2000) (referring to *Drye v. United States*, 528 U.S. 49 (1999) (holding that state law providing that disclaimer of an inheritance deprives the heir of any rights to the property does not prevent the imposition of a federal tax lien on the inheritance)).

The Michigan Court of Appeals rejected the implication in *Craft* that a lien could be attached to a debtors interest in property held in tenancy by the entirety without being immediately effective to sever the estate; that is, that the lien could attach to the debtors right to one-half of the proceeds on sale or divorce and to the entire property in case of survivorship. Some states recognize such liens in favor of private creditors. For a list of 10 such states, see Steve R. Johnson, *Fog, Fairness, and the Federal Fisc: Tenancy-by-the-Entireties Interests and the Federal Tax Lien*, 60 *Mo. L. Rev.* 839 (1995).

Logic versus Equity.

The unique incidents of tenancy by the entirety have been justified in terms of protecting a vulnerable spouse. *See, e.g., Craft*, 535 U.S. at 289 (Scalia, J., dissenting) (describing tenancy by the entirety as a form of property ownership that was of particular benefit to the stay-at-home spouse or mother). *See also* Mass. Gen. Laws Ann. ch. 209, § 1, 1A (prohibiting execution of a creditors claim so long as the subject property is the principal residence of the nondebtor spouse). Often, as in the present case, the property in question is the family home, but the rules of the common law concerning tenancy by the entirety are not limited to residential property. What if, instead of the family home, the property at issue had been extensive investment property? Should the Friend of Court have been able in that case to secure the imposition of the child support lien? The logic against that result would have been the same, but the equities would have been dramatically different.

The protection against creditors afforded by the rules of the common law concerning tenancy by the entirety can be justified in the case of anyone who voluntarily extends credit to one of two married persons. In that case, the creditor can be charged with actual or constructive notice of the state of the title to the borrowers property. But the rules cannot be so easily justified on that ground if the creditor in question was not in a voluntary relationship with the debtor. Should tort creditors or, as in the present case, child support creditors, who have no opportunity to evaluate the credit-worthiness of the debtor, also be barred from imposing a lien on the property? Again, the logic against that result is the same, but the equities are dramatically different.

RELATED LINKS: For additional discussion of tenancy by the entirety, see

■ 4 Thompson on Real Property, Second Thomas Edition, Ch. 33, Tenancies by the Entirety (David A. Thomas, ed.; chapter authored by John V. Orth, 2004).

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24 of 79 DOCUMENTS

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John V. Orth on AKG Real Estate, LLC v. Kosterman

2009 Emerging Issues 3471

John V. Orth on Relocating Easements and AKG Real Estate, LLC v. Kosterman, 717 N.W.2d 835

By John V. Orth

March 20, 2009

SUMMARY: In this Emerging Issues Analysis, Professor John V. Orth discusses the lively debate over the Restatement's position on the relocation of easements and explores the decision in *AKG Real Estate, LLC v. Kosterman* to reject the Restatement's position, concluding with advice to drafters of easements.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: A burdened landowner may not relocate an inconvenient easement without consent.

In 1998 a real estate company purchased undeveloped land from two tenants in common with the intention of building a residential subdivision. The deeds to the company expressly reserved a private road easement to an adjacent parcel owned by one of the grantors until such time as public road access is made available for said real estate upon the following described easement right of way, giving a metes and bounds description of the route of the private road. In addition, the deeds reserved recorded and/or existing easements. In fact, another express easement providing access to the adjacent parcel along the same route had been granted in a recorded deed in 1961.

Because the state Department of Transportation refused consent to open a public road along the described route, the developer proposed to relocate the right of way. The current easement owners refused, asserting that the new route would change their street address, put their house in an odd position relative to the road and neighboring houses, replace their direct access to the public highway with a circuitous route, and require them to reconfigure their driveway.

The developer sought a declaratory judgment that both the 1961 and 1998 easements terminated once it provided alternate public road access. The circuit court held that the easement reserved in the 1998 deed would terminate regardless of the location of the substitute route, but that the right of way (along the same route) granted in the 1961 deed would not. The court of appeals affirmed the holding concerning the 1998 easement, finding the reservation unambiguous, but reversed the holding concerning the 1961 easement, declaring that it could be modified in order to avoid a grossly inefficient allocation of resources.

Basing its decision solely on the 1961 easement, the Wisconsin Supreme Court reversed the court of appeals and held that the owner of a servient estate cannot unilaterally relocate or terminate an express easement. *Id.* 838. A majority of the justices used the case as an occasion to reject the latest Restatement position on modification and

relocation of easements. Two justices filed concurring opinions.

Making the simple complicated.

At one time, this case would have been speedily disposed of on grounds of deed construction. The 1998 deeds expressly reserved the easement until public road access is available along a specifically described route. Instead of accepting the plain meaning of this reservation, the circuit court disregarded the restriction on the location of the superseding route, and the court of appeals affirmed this decision. While not basing its decision on the 1998 deeds, a majority of the justices expressly noted: we question this interpretation. *Id.* 848 n. 11.

In addition, the 1961 deed of easement was a matter of record, and the title insurer had specifically listed it as an exception to title. Depositions apparently showed that the real estate developer had failed to inspect the chain of title, an omission the Supreme Court said bolsters our conclusion that the court of appeals should not have modified the 1961 easement. *Id.* 849. The Supreme Court went on to include a review of basic real estate practice: A buyer of real property is expected to determine the rights to the land he is about to purchase by consulting (1) the records in the office of the register of deeds; (2) other public records to discover rights which usually are not recorded in the office of the register of deeds; and (3) the land itself. *Id.*

The latest Restatement of Servitudes has raised questions about such a simple approach by providing that courts may modify easements due to changed conditions and that burdened landowners may relocate easements to permit development of the burdened land.

Judicial modification of an easement due to changed conditions.

The Restatement (Third) of Property: Servitudes § 7.10, Modification and Termination of a Servitude Because of Changed Conditions, restates in subsection (1) the common law rule that a servitude for a particular purpose terminates when it becomes impossible to use the servitude for that purpose, but liberalizes the rule by providing that a court may modify the servitude to permit the purpose to be accomplished. Subsection (2) states a new rule: a court may modify the servitude to permit other uses [of the servient estate] under conditions designed to preserve the benefits of the original servitude. Although § 7.10(2) seems primarily applicable to servitudes in the nature of real covenants, it literally applies to easements as well. See Restatement of Servitudes § 1.1 (The servitudes covered by this Restatement are easements, profits, and covenants.).

The court of appeals in the instant case invoked this section both as a justification for it to modify the easement by changing its location and as authorizing it to order the termination of the existing easement on condition the burdened landowner provided an alternate route. The Wisconsin Supreme Court reversed and refused to apply the modification provision of the Restatement, finding that the purpose of the 1961 easement had never become impossible; the easement owners were continuing to use it as a right of way.

Relocation of an easement by the burdened landowner.

The Restatement (Third) of Property: Servitudes § 4.8(3), Location, Relocation, and Dimensions of a Servitude, abandons the common law rule prohibiting relocation by a burdened landowner without the consent of the easement owner and replaces it with the civil-law rule in effect in Louisiana and a few other states (cmt. f): Unless expressly denied by the terms of the easement, the burdened landowner may relocate an easement to permit normal use or development of the servient estate, if the relocation is at the burdened landowners expense and does not (a) significantly lessen the utility of the easement, (b) increase the burdens on the owner of the easement in its use and enjoyment, or (c) frustrate the purpose for which the easement was created.

The court of appeals in the instant case invoked this section as authorizing it, in the absence of express provision to the contrary in the terms of the easement, to allow relocation and declared that the real estate company's proposed alternative route met all the necessary conditions. The Wisconsin Supreme Court refused to apply the relocation

provision of the Restatement, finding it an even more radical departure from the majority rule because it allows a court to modify an easement without concluding that conditions have changed. On the facts of the instant case, it is not difficult to imagine that an express provision against relocation would have been acceptable to both parties to the 1961 deed but was not included in the terms of the easement because of the state of law as it then was. The Supreme Court retained the traditional presumption that relocation without the easement owners permission is not allowed and declared that parties need not include a provision in an express easement to prevent unilateral modification or relocation. *Id.* at 846.

Property rights versus economic efficiency.

The new Restatement has provoked a lively debate in the courts and the literature, not only over the new rule on relocation, but even over which courts have adopted or rejected it. See Susan F. French, Relocating Easements: Restatement (Third), Servitudes § 4.8(3), 38 *Real Property, Probate & Trust J.* 1 (2004); John V. Orth, Relocating Easements: A Response to Professor French, 38 *Real Property, Probate & Trust J.* 643 (2004). A leading Massachusetts case, *M.P.M. Builders, LLC v. Dwyer*, 809 N.E.2d 1053 (Mass. 2004), is cited as adopting the Restatement position, although the court in that case required that burdened landowners secure prior judicial approval before relocating an easement something not expressly required by the Restatement. And although the court in *Dwyer* concluded that four other jurisdictions had adopted the Restatement rule on relocation, the Wisconsin Supreme Court reviewed the cases and found all of them distinguishable. *Dwyer*, it concluded, appears to stand alone. 717 N.W.2d at 845-46. Instead, the Wisconsin Supreme Court agreed with courts that had rejected the Restatement rule as a threat to the certainty of property rights and real estate transactions, as a catalyst for increased litigation, and as a means for purchasers of servient estates to reap a windfall. *Id.* 846. While recognizing that defending property rights in the present case ran the risk of sanctioning unneighborly and uneconomically productive behavior, the justices declared that nothing in the cited cases convinces us that we should sacrifice property rights in this case in favor of economic efficiency. *Id.* 845. The Vermont Supreme Court at about the same time also found the arguments against adopting the Restatement rule to be persuasive. *Sweezy v. Neel*, 904 A.2d 1050 (2006).

Concurring opinions.

Two justices seem to have thought that the defense of property rights did not require a decision whether to adopt either Restatement provision not § 7.10(2) on changed conditions, because there was not sufficient evidence that conditions had actually changed in this case; not § 4.8(3) on relocation, because the proposed relocation in this case would increase the burdens on the easement owner.

The bottom line.

The Restatement rule on relocation applies unless expressly denied by the terms of the easement. Going forward, drafters of easements would be wise to include in their documents specific provisions on relocation, as well as on the effect of future changes in use.

RELATED LINKS: For additional discussion of easements, see

■ Backman & Thomas, A Practical Guide to Disputes Between Adjoining Landowners--Easements (LexisNexis Matthew Bender).

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25 of 79 DOCUMENTS

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John V. Orth on Patterson v. Sharek

2009 Emerging Issues 3465

John V. Orth on Easements and Patterson v. Sharek

By John V. Orth

March 18, 2009

SUMMARY: John V. Orth explains why this easement case involving a car parked--not by the easement owner, but by the owner of the burdened estate--on a right of way demonstrates an important point concerning termination of easements by adverse use.

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ARTICLE: Parking on the right of way.

Record owners of a 34-foot-wide right of way sued the current owner of the burdened (servient) estate for unobstructed access. Thirty years ago, the burdened landowners predecessor in title had built a patio enclosed by a brick wall that extended 9 feet into the right of way, leaving 25 feet for access by the easement owners. Over the years, the burdened landowner and other prior owners frequently parked vehicles on the right of way, recently in such a way that allegedly interfered with the easement owners access.

Easements may be acquired by adverse use (also known as prescription) that is, by actual, exclusive, continuous, open and notorious use for the requisite period of time (in D.C. 15 years). In the same manner, easements may be terminated by adverse use; that is, the burdened landowner can extinguish an easement by adverse use of the burdened land in such a way that the burdened landowner re-acquires the easement. Since titles to both the easement and the burdened land are then in the same person, they merge and the easement is terminated. No one can have an easement in his own land.

Because the patio enclosure was a permanent obstruction, the trial court held that it had terminated the easement as to the 9-foot-wide strip of land that it had covered for more than 15 years. And, because parking interfered with the easement owners access, the trial court enjoined the burdened landowner from parking on the right of way. The court of appeals affirmed the lower courts decision concerning the permanent obstruction, but reversed its decision concerning parking by the burdened landowner. The case was remanded for a determination concerning whether the parking unreasonably interfered with the easement owners access.

Many cases concerning parking on the right of way have involved parking *by the easement owner* and courts have regularly enjoined it. Parking is not included in the right of access, so it exceeds the scope of the easement. Parking

imposes an additional burden on the burdened land. If it continued for a long enough period, it could result in the acquisition by the easement owner of a parking easement in addition to the easement of right of way. Parking *by the burdened landowner* is a different matter. Except in cases of exclusive easements giving the easement owner the right to exclusive use of the burdened land the burdened landowner may make any use of the burdened land that is not inconsistent with the easement. Unless the use by the burdened landowner is such that the easement owner could maintain an action for damages or an injunction, it cannot support an eventual claim of termination of the easement by adverse use. Unlike a permanent obstruction, such as the brick-wall-enclosed patio, ordinary parking is temporary and not indicative of a claim of adverse use by the one doing the parking. Absent a permanent obstruction maintained for the requisite period of time, the issue is properly not one of termination by adverse use but rather of unreasonable interference with the easement owners use.

Exclusive use.

The requirement for the acquisition (or re-acquisition) of an easement by adverse use that the use be exclusive has led to misunderstandings. Ordinarily, an easement entitles its owner to use the burdened land, but not to prevent use by the burdened landowner or, indeed, by owners of other easements in the same land, if any. Exclusive use in this case means merely use that is exclusive of the burdened landowners right to prevent it, not use that is exclusive of actual use by anyone else. *See, e.g., Keener Properties v. Wilson, 912 So. 2d 954 (Miss. 2005).*

In the case of extinguishing an easement by adverse use, the burdened landowner already has a right to use the right of way in any manner that does not unreasonably interfere with the easement owners use. Even significant use by the burdened landowner is not necessarily adverse to the easement owners right unless, of course, it excludes use by the easement owner.

Adverse use.

To terminate an easement by adverse use, the use by the burdened landowner must not only be actual, exclusive, continuous, open and notorious; it must also be adverse. Mere temporary interference, even unreasonable use, by the burdened landowner may not be indicative of the necessary adverseness, if the easement owner allows it in the ordinary give-and-take of neighborly accommodation, that is, impliedly grants permission. A presumption of neighborly accommodation is particularly appropriate where the right of way in question serves a residential lot in densely settled urban areas.

The end of an easement.

The case demonstrates an important point concerning termination of easements by adverse use. Unless an easement gives the easement owner the right to exclusive use, a burdened landowner may make any use of the burdened land that does not unreasonably interfere with use by the easement owner. Because the patio and wall in this case constituted a permanent obstruction, it was an exclusive and adverse use. But because the parking involved only a temporary obstruction, it was within the burdened landowners right unless, that is, it unreasonably interfered with the easement owners access. Even then, there might be a presumption of implied permission for temporary interruptions in use because of neighborly accommodation. If adverse use by the burdened landowner is found, the ordinary remedy is not to convert the easement by judicial decree into an exclusive one, but to enjoin the unreasonable interference with the easement owners use.

RELATED LINKS: For additional discussion of easements, see

■ Backman & Thomas, *A Practical Guide to Disputes Between Adjoining Landowners--Easements* (LexisNexis Matthew Bender)

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26 of 79 DOCUMENTS

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John V. Orth on Hudson Savings Bank v. Austin

2009 Emerging Issues 3458

John V. Orth on the 11th Amendment and Hudson Savings Bank v. Austin

By John V. Orth

March 18, 2009

SUMMARY: John V. Orth explains how a routine mortgage foreclosure sale became far from routine when it led to an analysis of the Eleventh Amendment by the First Circuit Court of Appeals.

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ARTICLE: From foreclosure to federal question.

After a routine mortgage foreclosure sale, Hudson Savings Bank of Massachusetts was left holding a surplus. Since the property had been subject to tax liens by both the state and federal governments, the bank filed a routine interpleader action in state court, naming the mortgagor, Massachusetts, and the United States as defendants and seeking discharge from further liability. As is routine, the United States removed the case to federal court, and the mortgagor, who made no claim on the surplus, dropped out as a party. But what followed was far from routine. The state moved for dismissal on grounds of the Eleventh Amendment, and the federal district court agreed. On appeal, the First Circuit Court of Appeals reversed, and began the process of clarifying the circuits approach to such cases, but did so in a very cautiously written opinion.

States rights.

The Eleventh Amendment was adopted in 1795 to overturn the Supreme Courts decision in *Chisholm v. Georgia*, 2 U.S. 419 (1793), which held that the Court had original jurisdiction over controversies between a state and citizens of another state. The Amendment exactly negates that holding: The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State or by Citizens or Subjects of any Foreign State. Caselaw over the last two centuries has resulted in the Amendment meaning both more and less than its words imply. For example, the Amendment has supported the holding that the federal courts lack jurisdiction over suits against a state brought by any private party, not only by Citizens of another State unless the state consents. *Seminole Tribe v. Florida*, 517 U.S. 44 (1996). But the Supreme Court has refused to extend the Amendments reach to include suits against a state brought by the *United States*. *Employees of Dept of Pub. Health & Welfare v. Dept of Pub. Health & Welfare*, 411 U.S. 279 (1973). For more on the complicated historical development, see John V. Orth, *The Judicial Power of the United States: The Eleventh Amendment in American History* (1987).

Because the United States had removed the current case to federal court before the bank had been discharged and dismissed as a party by the state court, the suit was still technically one brought by a private party against the state -- and, of course, the United States. Recognizing that the right of a state to litigate a private party's claim against it in its own courts is constitutionally assured, the federal appellate court proceeded cautiously, refusing to announce a categorical rule spelling out a protocol for litigating such cases in the future. 479 F.3d 102, 104-05. It did, however, categorically rule out dismissal by the federal district court as the proper procedure, thereby overruling several district court cases. The lower federal courts' only remedy for a finding of a lack of jurisdiction in Eleventh Amendment cases is a remand to state court. Reasoning that this case was in reality a dispute between the state and the federal government over the surplus from the foreclosure sale, the appellate court indicated that the proper procedure was to stay the bank's request for discharge of liability as against the state, pending determination of the relative priority of the federal and state claims. If the district court found that the federal lien had priority, it should order the satisfaction of the lien. In the event any claim against the state by the bank remained, the case was to be remanded to state court.

What was not decided.

Picking its way carefully because of the uncertain constitutional terrain, the First Circuit Court of Appeals limited its holding to the specific facts of this case: (1) the bank was seeking no relief except a discharge of liability; (2) no private party asserted any claim to the surplus funds; and (3) the sum of the state and federal tax liability exceeded the amount of those funds. 479 F.3d 102, 109. As the court admitted, it left unresolved the most difficult aspect of the underlying constitutional question, the resolution of the priority of other claims. 479 F.3d 102, 104. What if the bank had sought more than a mere discharge of liability? What if a private party had asserted a claim on the funds?

It seems essential to the supremacy of federal law that a federal court determines the priority of the federal lien in all cases. Should the federal court not find the federal lien superior to all others, the case should be remanded to the state court for determination of the relative priority of any other (non-federal) claims that implicate a claim against the state, although it is possible that the federal court could determine the priority of other claims if state and federal law concerning them are essentially the same. See, e.g., *Horizon Bank & Trust Co. v. Flaherty*, 309 F. Supp. 2d 178 (D. Mass. 2004). The possibility certainly exists, however, that federal and state courts could reach conflicting conclusions in some cases. Except to the extent of the federal court's determination of the priority of the federal claim, it is uncertain which court should have the final say in that eventuality. As the First Circuit Court of Appeals candidly admitted, conducting a single lawsuit in two complementary court systems is inefficient and burdensome, 479 F.3d 102, 109, but it seems to be a burden required by the current state of Supreme Court jurisprudence on the Eleventh Amendment.

RELATED LINKS: For discussions on mortgage foreclosures, see

- Bergman on New York Mortgage Foreclosures (LexisNexis Matthew Bender);
- Powell on Real Property ch. 37, Mortgages and Mortgage Foreclosures (Michael Allan Wolf ed., LexisNexis Matthew Bender).

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John V. Orth is William Rand Kenan, Jr. Professor of Law at the University of North Carolina at Chapel Hill, where he has taught for 30 years. He is the recipient of the University's award for excellence in teaching. His undergraduate degree is from Oberlin College, and he has a law degree and Ph.D. in history from Harvard University. He contributes the chapters on concurrent estates to *Thompson on Real Property*, Thomas Edition, as well as annual articles in the series *Reappraisals in the Law of Property*, published in *The Green Bag*. He is the author of *How Many Judges Does It Take to Make a Supreme Court*, and *Other Essays on Law and the Constitution* (2006); *Due Process of Law: A Brief History* (2003); *The North Carolina State Constitution with History and Commentary* (1993); *Combination and Conspiracy: The Legal History of Trade Unionism, 1721-1906* (1991); and *The Judicial Power of the United States: The Eleventh Amendment in American History* (1987). Professor Orth has published numerous law review articles on constitutional law, property law, and legal history. His publications have been cited by federal and

state courts, including the United States Supreme Court and the North Carolina Supreme Court.

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27 of 79 DOCUMENTS

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Paula A. Franzese on Goldstein v. Pataki

2009 Emerging Issues 3386

Paula A. Franzese on Eminent Domain and Goldstein v. Pataki--The Possibility of Heightened Judicial Scrutiny Relating to "Pretext" Public Use Challenge

By Paula A. Franzese

February 23, 2009

SUMMARY: In this Emerging Issues Analysis on eminent domain, Paula A. Franzese explains why the 2nd Circuit's decision in *Goldstein v. Pataki* is particularly significant in the way it opened the door to the possibility of a new remedy for pretextual declarations of public use.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *Eminent domain, or the capacity of government to take private property for public use in exchange for just compensation, has become one of the more controversial issues of our time.* On the one hand, the takings power, found in the Fifth Amendment of the U.S. Constitution, has long been interpreted as recognizing that the rights of the few must sometimes yield to the collective's best interests, and that government is the best fiduciary of that collective interest. Yet, in a post-*Kelo* world, and against a backdrop of various economic stressors, governmental condemnation proceedings have been viewed with increased skepticism and, in some vicinages, abject dismay. While proponents of governmental intervention to spur economic growth and revitalization laud the takings power as a worthy tool, critics point to its potential for abuse, overreaching, corruption and unnecessary intrusiveness.

Governmental takings must be for public use, in accord with the terms of the constitutional imperative. Still, public use has been interpreted broadly, to include, for example, the use of condemnation proceedings to take private property to make way for private development to accomplish economic revitalization. Typically, this prerogative is invoked to combat blight. Blight, however, is a relative construct. Labeling a given vicinage as blighted has been used by government to transfer land from one private owner to another, with the requisite public use found to reside in the end result of economic growth. This ends justifying the means approach has led to the revitalization, for example, of the Times Square district in New York City, as well as various low-income neighborhoods in Boston. Proponents laud the rise in jobs, decrease in crime, aesthetic appeal, and enhanced property values as desirable consequences of the governmental intervention. Opponents of this strand of taking indict the practice as heavy-handed, unfair to targeted landowners and destined to contribute to tides of gentrification.

The case of *Goldstein v. Pataki*, 516 F. 3d 50 (2008), represents one manifestation of the economic

revitalization justification for takings. In that case, the City of New York invoked the takings power to condemn private property in Brooklyn to make way for a sporting arena for the New Jersey Nets and to erect 2,250 units of affordable housing. The Court of Appeals for the Second Circuit found that the taking would serve several valid public uses, including the redress of blight, the construction of a sporting arena, and the creation of affordable housing. **Noting that a pretext argument could provide a sound basis for a public use challenge under *Kelo v. City of New London*, 545 U.S. 469 (2005), the court held that such a claim could not succeed on the facts before it because a reasonable juror could not conclude that the public purposes to be served by the renewal project were nothing more than pretexts.**

The court embraced a posture of judicial restraint, long-applied in this setting, to afford considerable deference to the legislative determination of public use. Thus, under a rational basis standard of review, the governmental plan passed muster. Notably, the court did add that, in appropriate circumstances, a pretext argument could apply and could void the legislative determination of a public use. **Striking down the plaintiffs pretext argument**, the court stated:

We reach this conclusion preserving the possibility that a fact pattern may one day arise in which the circumstances of the approval process so greatly undermine the basic legitimacy of the outcome reached that a closer *objective* scrutiny of the justification being offered is required. In this area, "hypothetical cases . . . can be confronted if and when they arise.

Goldstein, 516 F.3d at 64 (internal citations omitted).

Thus, while the opinion reaffirmed the chain of logic that extended from the U.S. Supreme Courts seminal pronouncements in *Berman v. Parker* to *Kelo v. City of New London*, **the court opened the door to the possibility of a constitutional remedy, in appropriate circumstances, for pretextual declarations of public use. The court also preserved plaintiffs right to file their complaint in state court, despite the filing in federal court.** The impact of such right on the normative values served by federalism remains unclear, as plaintiffs have not received an independent resolution of their case based upon a state courts determinations.

In April 2008, the U.S. Supreme Court denied plaintiffs request for *certiorari*. To the extent that plaintiffs state court basis for review runs its course, it may require years of litigation to more clearly flesh out the import of the *Goldstein* decision as well as the potential differences between federal and state precedent regarding eminent domain.

Doctrinal Antecedents: Supreme Court Precedent--Posture of Judicial Deference to Local Determinations

The Fifth Amendment affords government the power to take private property for public use, in exchange for just compensation. The public use standard has been expansively construed by the Supreme Court, which has long embraced the broader and more natural interpretation of public use as public purpose. *Kelo v. City of New London*, 545 U.S. 469, 480 (2005). For example, in *Berman v. Parker*, 348 U.S. 26 (1954) the Court held that blighted areas, meaning locales that are economically impoverished or challenged, could be taken to allow for economic revitalization, even when the revitalization is to come at the behest of private initiative. The Court remarked in that case that [i]t is within the power of the legislature to determine that the community should be beautiful as well as healthy, spacious as well as clean, well-balanced as well as carefully patrolled. *Berman*, 348 U.S. at 33. The cases outcome signaled a strong posture of judicial deference to the legislative branch in making determinations as to the purpose, scope and nature of the given taking.

In *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984), the Court reaffirmed the posture advanced in *Berman*. Hence, the Hawaii State Legislatures determination that the taking of private property from one group of owners for the benefit of another group of owners satisfied the public use test, mindful of the legislative determination that various salutary purposes would be served by the plan. Specifically, the legislature was acting to combat the social and economic ills caused by a pattern of land ownership that vested title to vast portions of property only to a select

few. The *de facto* oligopoly that Hawaii's unique history imposed deprived its citizens, and, specifically in this case, tenants, of the opportunity to purchase land at market value. Hence, the statutory initiative, aimed at affording that opportunity to tenants by divesting their landlords, was entitled to considerable judicial deference, mindful of the legislative findings of the various public benefits to be advanced.

In *Kelo v. City of New London*, 545 U.S. 469 (2005), a sharply divided Supreme Court reached the conclusion that a taking for economic revitalization is, in fact, a taking for public use. Writing for the majority, Justice Stevens remarked that the Supreme Court will defer to the states' wisdom and that government, in its role as fiduciary for the public welfare, must be afforded the latitude to do its good works. Again, *Kelo* committed to a posture of judicial deference to local determinations, noting that courts have only a limited role to play when passing on such determinations.

That spirit of deference applies as well to give states the power to limit the use of eminent domain. As Justice Stevens stated, We emphasize that nothing in our opinion precludes any State from placing further restrictions on its exercise of the takings power. *Kelo*, 545 U.S. 469, 489. As a result, many state legislatures and state courts have been more exacting in their interpretation and application of the public use test and more aggressive in promoting a set of hurdles and obstacles that government must overcome to satisfy the Fifth Amendment guarantee. See Hyllton, Callies, Mandelker & Franzese, *Property Law and the Public Interest: Cases and Materials*, 255 (3d ed. LexisNexis 2007).

For an additional discussion of states' responses to *Kelo*, see *Powell on Real Property* § 79F.03[3][b][iv] (Michael Allan Wolf ed., LexisNexis Matthew Bender).

Second Circuit Analogues

The Second Circuit precedent to guide the result in *Goldstein* tracks the approach contained in *Kelo*, *Midkiff*, and *Berman*. In adopting the Supreme Court's reasoning and applying the relevant standard of review, the Second Circuit has held that the taking of private property meets the constitutional requirements when it is rationally related to a legitimate public purpose. See *Rosenthal & Rosenthal, Inc. v. New York State Urban Dev. Corp.*, 771 F.2d 44, 45 (2d Cir. 1985). In *Rosenthal*, the Second Circuit held that once the state proves that the surrounding area is blighted, it may condemn even those parcels that are not blighted in order to improve the overall area. *Id.* Hence, condemnation of a non-blighted building would be permissible, no matter that the target was structurally sound and notwithstanding the fact that the subject property would eventually be transferred to private developers. The court stated boldly that the power of eminent domain is merely the means to the end. *Id.* Thus, so long as the legislature has a legitimate purpose and uses rational means to achieve that purpose, federal courts must defer to the legislative judgment. *Id.*

The *Goldstein* court relied on *Rosenthal* to reject plaintiffs' challenge to governments' exercise of eminent domain. *Goldstein*, 516 F.3d 50, 57. In *Goldstein*, plaintiffs consisted of fifteen property owners whose homes and businesses were scheduled to be condemned so that a new stadium for the New Jersey Nets National Basketball Association franchise could be erected. *Id.* at 53-54. Plaintiffs alleged that all of the public uses the defendants advanced for the Project were merely pretexts for a private taking that violates the *Fifth Amendment*. *Id.* at 53.

Citing *Rosenthal*, the court determined that, viewed objectively, the project bore at least a rational relationship to several well-established categories of public uses. *Goldstein* is in accord with the long line of Supreme Court cases to apply considerable deference to matters involving the interpretation of public use. Notably, the court stated that the federal courts' role in assessing the propriety of a given taking should be one of patrolling the borders not second-guessing every detail in search of some illicit improper motivation. *Id.* at 57.

A New Constitutional Standard

Interestingly, **the Goldstein court alluded to the possibility that heightened judicial scrutiny might attach if and when warranted by the particular facts and circumstances before the court.** While the record before it did not compel application of such heightened review, the court preserved the possibility that a fact pattern may one day arise in which the circumstances of the approval process so greatly undermine the basic legitimacy of the outcome reached that a closer *objective* scrutiny of justification being offered is required. *516 F.3d 50, 63*. The contours and dimensions of such circumstances remain to be seen.

RELATED LINKS: For an additional discussion of states responses to Kelo, see

- Powell on Real Property § 79F.03[3][b][iv] (Michael Allan Wolf ed., LexisNexis Matthew Bender).

Professor Franzese is also the author of Paula A. Franzese on Twin Rivers: New Twin Rivers Test Applied to Homeowners Associations Restrictions on Residents Speech, available on Lexis.com

- (2008 Emerging Issues 1552).

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Paula **Franzese** is the Peter Rodino Professor of Law at Seton Hall Law School. She received her B.A., *summa cum laude*, Phi Beta Kappa, from Barnard College, Columbia University, where she was awarded the Bryson Prize, Alpha Zeta Fellowship, Marion Churchill White Prize, Davidson-Foreman Foundation Award and Barnard Alumnae Fellowship, and her J.D. from Columbia University School of Law, where she was an International Fellow, Teaching Fellow and recipient of the prestigious Rosenman Prize for excellence in public law courses. She was a litigator with Cahill, Gordon, and Reindel in New York City, where she also served as a member of the NYC Housing Court Reform Project and the Governors Task Force on Life and Law. She clerked for Justice Alan B. Handler of the New Jersey Supreme Court. Professor Franzeses casebook, *Property Law and the Public Interest* (Lexis Nexis, 2003), (with Callies, Mandelker & Hylton), is heralded as one of the first to expansively explore the public interest dimensions of property law. Her scholarship in the area of property includes critical examination of common interest communities and the dilemma of privatization, the law of servitudes, exclusionary zoning, affordable housing, adverse possession doctrine and takings law. She joined in the submission of an amicus brief in the *Kelo* Case, and has written and presented on takings law reform. In 2006 she was named to the editorial board of the *Land Use and Environmental Law Review*, a peer-reviewed scholarly journal. She has published extensively on the anatomy of ethics reform of state and local government, and in the areas of commercial and contracts law, legal pedagogy and attorney professionalism. She is a contributor to two new books: *Americas Second Gilded Age--Perspectives on Law and Class Differences* (NYU Press, 2006) and *The Affective Assistance of Counsel: Practicing Law as a Healing Profession* (Carolina Academic Press, 2007). She is the Gilberts "Legend of the Law" in property (Harcourt Brace, 1996) and is the author and presenter of an audiotape and CD collection on property (Thomson, 2003).

Professor **Franzese** is also the author of Paula A. Franzese on Twin Rivers: New Twin Rivers Test Applied to Homeowners Associations Restrictions on Residents Speech, available on Lexis.com (2008 Emerging Issues 1552).

Nationally acclaimed for her teaching, Professor **Franzese** is the unprecedented eight-time recipient of the Seton Hall Law Student Bar Associations Professor of the Year Award. Nominated for the Robert Foster Cherry Prize for Great Teaching, she has been named "Exemplary Teacher" by the American Association of Higher Education and was ranked the Top Law Professor in New Jersey by the New Jersey Law Journal.

In 2006, Professor **Franzese** was appointed chair of the newly empowered State Ethics Commission by Governor Jon Corzine. In 2005, she was appointed by Governor Corzine to serve on the gubernatorial transition teams Ethics and

Policy Management Task Force. In 2004, Professor **Franzese** and New Jersey Supreme Court Justice Daniel J. O'Hern were appointed Special Ethics Counsel to Governor Codey. In that capacity, they submitted the most comprehensive ethics audit and reform agenda of its kind, resulting in significant ethics reform of the Executive Branch of State Government and promulgation of New Jersey's first Uniform Ethics Code. Their work has garnered national attention, as other states take up the task of ethics reform.

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28 of 79 DOCUMENTS

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Bernhardt on California National Bank v. Woodbridge Plaza LLC

2009 Emerging Issues 3299

Professor Roger Bernhardt on California National Bank v. Woodbridge Plaza LLC, 164 Cal. App. 4th 137, 78 Cal. Rptr. 3d 561, 2008 Cal. App. LEXIS 9387 (Cal. App. 4th Dist. 2008)

By Roger Bernhardt

January 21, 2009

SUMMARY: Get expert commentary on the California appellate court decision in *California National Bank v. Woodbridge Plaza LLC*, 164 Cal. App. 4th 137 (2008), an action involving the interpretation of a lease provision dealing with calculation of rent for the extended term of the lease.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Any time parties are negotiating a lease that will require a new rent to be set 25 years in the future, the need to account for unforeseen contingencies is apparent. Both landlord and tenant here attempted to do that by providing that, if the lease was renewed thereafter, rent in the 26th year would be at the then "prevailing rate." The tenant showed additional foresight by adding that the future rent was capped, not only by the rent paid by the other bank in the shopping center, but also by the rent that was paid by the other banks "successor." What both parties failed to do, however, was to define "successor" so that a court in 2008 could determine whether that term was intended to mean the latest occupant of the same premises (medical professionals and a beauty salon), or rather another financial institution in the shopping center, whether or not its location had changed.

When the parties have not themselves provided a necessary definition, the courts will need to do it for them, with a result that one of them is almost certain to dislike. In this case, it was the tenant who suffered by the judicial interpretation but the outcome might have just as easily hurt the other side had bank rentals been lower rather than higher than other commercial rates.

In circumstances similar to those that occurred in this case, i.e., when a rent is to be affected by what a third party is paying, the more the original parties say about that future rent setter, the less they will leave to chance and the vagaries of judges. Thus, for instance, had the lease defined "successor" as an institution doing financial business anywhere in the shopping center, rather than the next occupant in that same location regardless of the business activity going on, then this litigation might have been avoided. One still cannot be sure because even had the former definition actually been used, there could still be disagreements as to whether mortgage brokers, ATM machines, etc., would qualify.

Similar uncertainty could have also easily undermined the other component of the formula: the "prevailing" rate. One expert in this case used a business purpose standard and looked at rents paid by other financial institutions, whereas

the other expert used a locational test instead, indifferent to the business activities of the other tenants. That issue also could have been resolved by the parties themselves through more specific language in their original agreement.

On the one hand, one must be cautious about praising specificity 25 years ahead of time. There is so much that can change in the distant future as to counsel caution in trying to lock too much into a straitjacket. On the other hand, when the issue is a cap on the rent (rather than the rent setting formula itself), a tenant would probably always prefer that the terms be as broadly stated as possible.

RELATED LINKS: For additional discussion on construction of leases, see

- 6-151 California Real Estate Law & Practice § 151.24

For additional discussion on rent and rent control, see

- 6-171 California Real Estate Law & Practice § 171.26;
- 6-171 California Real Estate Law & Practice § 171.27

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Roger Bernhardt, Professor of Law at Golden Gate University in San Francisco, is author of Bernhardt's California Real Estate Codes (LexisNexis), California Mortgage and Deed of Trust Practice (CEB), as well as numerous books on Property and Mortgage Law for students. He is also Editor of CEB's California Real Property Law Reporter and Bernhardt's Mortgage Law Newsletter. (RBernhardt@GGU.edu)

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29 of 79 DOCUMENTS

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Professor Sinclair on Principles of Lease Interpretation in Virginia.

2008 Emerging Issues 3192

Comments by Professor Kent Sinclair and Gessner H. Harrison on the Supreme Court of Virginia's Opinions in *Levisa Coal Co. v. Consolidation Coal Co.*, 276 Va. 44 (2008), *Pocahontas Mining LLC v. CNX Gas Co.*, 276 Va. 346 (2008), and *Nextel WIP Lease Corp. v. Saunders*, 276 Va. 509 (2008).

By Kent Sinclair and Gessner H. Harrison

December 21, 2008

SUMMARY: Professor Kent Sinclair discusses the principles of lease interpretation in Virginia as well as effectively ascertaining the rights granted by a lease and the determination and resolution of lease ambiguities in light of the Supreme Court of Virginia's opinions in *Levisa Coal Co. v. Consolidation Coal Co.*, 276 Va. 44 (2008), *Pocahontas Mining LLC v. CNX Gas Co.*, 276 Va. 346 (2008), and *Nextel WIP Lease Corp. v. Saunders*, 276 Va. 509 (2008).

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

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ARTICLE: Undoubtedly, the most frequently litigated issue in lease disputes concerns whether certain activities are either permitted or prohibited under the language appearing on the face of the lease. In three recent cases, *Levisa Coal Co. v. Consolidation Coal Co.*, 276 Va. 44 (2008), *Pocahontas Mining LLC v. CNX Gas Co.*, 276 Va. 346 (2008), and *Nextel WIP Lease Corp. v. Saunders*, 276 Va. 509 (2008), the Supreme Court of Virginia summarized, applied, and reaffirmed longstanding principles of Virginia law used to ascertain the specific rights granted by a lease, to determine whether lease language is ambiguous, and to resolve any such ambiguities. In doing so, the Court provides valuable guidance to lessors, lessees, and their counsel that can be used to evaluate the strengths and weaknesses of the positions taken by the parties respecting both the scope of the rights granted by their lease and whether the lease language they rely upon for their respective positions will be interpreted and applied in the manner they advocate, should the parties require formal litigation to resolve their dispute. This Commentary examines the disputes that the Court resolved in these cases, highlights the principles of law that the Court relied upon to resolve each dispute, and discusses the impact of the holdings reached in each case.

Background. In *Levisa Coal Co.*, the predecessor in interest of the Levisa Coal Company ("Levisa Coal") acquired the solid mineral estate of certain parcels of property situated in Buchanan County, Virginia in 1937 via a severance deed that did not expressly convey the right to use any part of the conveyed estate or easements attendant thereto to support mining activities on other lands. In 1956, Levisa Coal, as lessor, entered into a long-term mining lease granting the lessee, another coal company, the "sole and exclusive right and privilege of mining and removing" coal on the same properties that were the subject of the 1937 severance deed. However, the 1956 mining lease reserved unto Levisa Coal

certain other rights, including the right to own and control the leased premises and the right to explore for, mine, and recover the coal, gas, ores, and other minerals not within the scope of the lease. The 1956 mining lease also provided the lessee coal company with certain rights, including the general right to make any use of the leased premises which it might deem needful or convenient in carrying on its mining or other operations and the right to "dump water or refuse on said premises," but limited such rights to those which Levisa Coal owned and had the right to lease. The 1956 mining lease also did not expressly convey to the lessee coal company any right to use the leasehold for the support of mining operations on other lands. In 1993, another mining company that was a direct competitor of Levisa Coal acquired all of the assets and liabilities of the lessee coal company and transformed it into a wholly-owned subsidiary. A few years after this acquisition, the competing mining company, as the parent company of the lessee coal company, began storing excess water from its mining operations on other property in "idled" mines that were located on the leasehold governed by the 1956 mining lease. After two of these idled mines became completely full with water, the competing mining company began to store water in a third idled mine at the rate of 2,500 gallons per minute.

Levisa Coal subsequently filed a complaint for injunctive and declaratory relief against the competing mining company, asserting that irreparable harm to its property and business interests would result if this practice were permitted to continue and that the competing mining company had no right under the 1956 mining lease to store water in the mines that the lessee mining company had idled. Following extensive discovery and an ore tenus hearing, the circuit court ruled that Levisa Coal had not met its evidentiary burden for obtaining a preliminary injunction and issued a declaratory ruling that the competing mining company, as the parent of the lessee coal company, had the right to store water in the mine at issue. Levisa Coal appealed, arguing *inter alia* that language of the 1956 lease stating that the lessee coal company could make "any use of the leased premises which [it] may deem needful or convenient in carrying on its mining or other operations" had been misinterpreted by the circuit court as granting it a right to store water generated by mining operations on other properties in idled mines on the leasehold. In *Pocahontas Mining LLC*, the predecessor in interest of the Pocahontas Mining Limited Liability Company ("Pocahontas"), as lessor, entered into a lease in 1998 that granted the lessee, a coalseam gas company, certain rights in the coalseam gas located beneath the surface of Pocahontas' property. The 1998 lease specifically provided that Pocahontas "grant[ed], lease[d] and let[] exclusively unto" the coalseam gas company "any and all rights" Pocahontas had "to all of the coalseam gas . . . underlying" the property, "together with any and all rights necessary or convenient to develop, produce, market and sell said coalseam gas" (collectively, "production rights"). The 1998 lease provided that these production rights "include[d], but [were] not limited to, the exclusive rights of exploring, drilling, producing, gathering, transporting, and selling the coalseam gas, the rights to construct and maintain all pipelines, tanks, structures, and utility lines . . . deem[ed] necessary and convenient for the production and/or transportation of coalseam gas or other gas, whether or not owned, leased, or produced by [l]essee, from this and other lands, whether or not owned or leased by [l]essee." The 1998 lease also contained a clause reserving certain rights unto Pocahontas, specifying that "[e]xcept as granted and leased herein, there is excepted and reserved to [Pocahontas] the entire ownership and control of the lands included herein and the oil, gas, coal, stone, sand, water, timber, and other minerals and products therein and thereon, with the right to use and dispose of the same for all purposes other than those for which this [l]ease is made except as such ownership and control may be leased to other parties by other instruments." In 2006, Pocahontas entered into a right of way agreement with a natural gas company granting this company "the exclusive right to construct, operate, and maintain a pipeline to transport natural gas across, through, upon, over, and under a portion of" the same property owned by Pocahontas that was the subject of the 1998 lease. In accordance with the right-of-way agreement, the natural gas company began to construct a pipeline to transport natural gas on the surface of Pocahontas' property. Shortly thereafter, agents of the successor in interest to the coalseam gas company under the 1998 lease installed gates and prevented representatives of Pocahontas or the natural gas company from obtaining access to the property. Pocahontas and the natural gas company filed a complaint for a declaratory judgment interpreting the respective rights of the parties under the 1998 lease and the 2006 right-of-way agreement. The circuit court granted summary judgment in favor of the lessee's successor in interest, finding the lease to be unambiguous and that it conferred exclusive rights, including the rights to construct and maintain all pipelines and all structures on the property and to transport coalseam gas or other gas on, over, under or through the property. Pocahontas and the natural gas company pursued separate interlocutory appeals, arguing *inter alia* that the circuit court had erred in interpreting the scope of the exclusivity of the rights conferred on the coalseam gas company

by the 1998 lease.

In *Nextel WIP Leasing Corp.*, the owners of property situated on the top of a mountain leased a 50-foot by 50-foot area of their mountaintop property to Nextel WIP Leasing Corporation ("Nextel"). After Nextel constructed an 80-foot-high telecommunications tower, the lease was assigned to a cellular tower limited liability company, which applied for a special use permit to allow the construction of a second 80-foot telecommunications tower on the leased premises. The special use permit was approved, but when construction of the second telecommunications tower began, the landowners filed a motion for declaratory judgment against Nextel and the cellular tower company alleging that the lease permitted construction of only one 80-foot telecommunications tower. Nextel and the cellular tower company each responded by filing, *inter alia*, a motion for summary judgment. Nextel argued in its motion that the lease was "unambiguous and . . . clearly allows Nextel and its assignees to build a second telecommunications tower on the [p]remises." In their motion, the cellular tower company asserted that language appearing in "three clear and unambiguous provisions" of the lease agreement "expressed the parties' intent 'that more than one tower may be constructed on the [l]eased [p]remises.'" The first of these three provisions, addressing the intended use of the leased premises, stated in pertinent part that "[t]he premises may be used . . . for the transmission and receipt of wireless communication signals in any and all frequencies and the construction and maintenance of *towers*, antennas, or buildings, and related facilities and activities." The second provision, concerning the lessor's representations and warranties, stated in pertinent part that the lessor "represents and warrants that . . . [l]essee's [i]ntended [u]se of the [p]remises as a site for the transmission and receipt of wireless communication signals; for the construction and maintenance of *towers*, antennas or buildings; and related facilities is not prohibited by any covenants, restrictions, reciprocal easements, servitudes, subdivision rules or regulations." The third provision, concerning improvements, stated in pertinent part that the lessee "shall have the right, at Lessee's sole cost and expense, to erect and maintain on the Premises improvements, personal property and facilities, *including without limitation, one (1) tower*, a structural tower base, radio transmitting and receiving antennas, communications equipment, an equipment cabinet or shelter and related facilities." The circuit court heard oral argument on the motions for summary judgment and denied them, holding that the lease agreement was ambiguous and that parol evidence would be admissible to determine the parties' intent when the lease was negotiated. At the conclusion of an ore tenus hearing held for the taking of parol evidence, the circuit court ruled in its final order that the lease permitted construction of only one communication tower. Nextel and the cellular tower company appealed, arguing that the circuit court erred in interpreting the lease provisions as permitting the erection of only one telecommunications tower on the leased premises.

Legal Principles. In resolving the disputes concerning the rights granted by the leases at issue in these cases, the Court relied on the following well-established principles of Virginia law:

. Rules of contract interpretation apply to the interpretation of leases: In *Levisa Coal Co.* the Court observed that "[l]ike all leases, a mining lease is a contract." Based upon this observation, the Court applied general rules of contract interpretation to resolve the question concerning the scope and meaning of language appearing in the lease at issue. Similarly, in *Nextel WIP Leasing Corp.*, the Court applied general rules of contract interpretation to resolve the dispute concerning the meaning of language appearing in the provisions of the lease at issue in that case, although it did not explicitly state that the reason why such principles applied was due to the fact that a lease is a type of contract. However, in *Pocahontas Mining LLC*, the Court clarified any doubt by making the explicit statement that "[i]n our analysis of . . . lease terms, we rely on established principles of contract interpretation."

. When reviewing a trial court's interpretation of a lease, a *de novo* standard applies: In *Levisa Coal Co.*, the Court observed that in reviewing a trial court's interpretation of a lease, it was well-established that a *de novo* standard of review applied. Citing *Video Zone, Inc. v. KF&F Properties, L.C.*, 267 Va. 621, 625, 594 S.E.2d 921, 923 (2004), *Eure v. Norfolk Shipbuilding & Drydock Corp.*, 263 Va. 624, 631, 561 S.E.2d 663, 667 (2002), and *Wilson v. Holyfield*, 227 Va. 184, 187-188, 313 S.E.2d 396, 398 (1984), the Court explained in both *Pocahontas Mining LLC* and *Nextel WIP Leasing Corp.* that under the *de novo* standard of review, it was "not bound by the trial court's interpretation of the contract provision at issue" and that instead, it "ha[d] an equal opportunity to consider the words of the contract within the four corners of the instrument itself." Citing *Video Zone*, 267 Va. at 625, 594 S.E.2d at 923, the Court explained in

Nextel WIP Lease Corp. that the *de novo* standard of review applied because the question of "[w]hether contractual provisions are ambiguous is a question of law and not of fact."

. When required to interpret lease terms, the focus of the court's analysis is to determine intent of the contracting parties based on language employed in their lease, which is to be considered as a whole: Relying on *Flippo v. CSC Assocs. III, L.L.C.*, 262 Va. 48, 64, 547 S.E.2d 216, 226 (2001), *Langman v. Alumni Ass'n of the Univ. of Va.*, 247 Va. 491, 498-499, 442 S.E.2d 669, 674 (1994), and *Camp v. Camp*, 220 Va. 595, 597, 260 S.E.2d 243, 245 (1979) for support, in *Pocahontas Mining LLC*, the Court explained that "[a] court's primary focus in considering disputed contractual language is to determine the parties' intention," and that this determination should be accomplished "wherever possible, from the language the parties employed in their agreement." Continuing, the Court instructed that "[i]n ascertaining the parties' intention regarding specific contract provisions," it was compelled to "consider the document as a whole," citing for support its prior decisions in *American Spirit Ins. Co. v. Owens*, 261 Va. 270, 275, 541 S.E.2d 553, 555 (2001), *Lansdowne Development Co. v. Xerox Realty Corp.*, 257 Va. 392, 401, 514 S.E.2d 157, 161 (1999), *Westmoreland-LG&E Partners v. Virginia Elec. & Power Co.*, 254 Va. 1, 11, 486 S.E.2d 289, 294 (1997), and *Langman*, 247 Va. at 498-499, 442 S.E.2d at 675. The Court reaffirmed this principle in *Nextel WIP Leasing Corp.*, instructing that it "cannot view [a lease provision] in isolation but must consider it along with all the other provisions of the lease" because "[a] contract 'must be read as a single document' and its meaning 'is to be gathered from all its associated parts,'" quoting *Berry v. Klinger*, 225 Va. 201, 208, 300 S.E.2d 792, 796 (1983), for support.

. Mere fact of a disagreement between the parties as to the meaning of specific lease terms or provisions is not evidence that the lease is ambiguous, and any ambiguity must appear on the face of the lease: In *Pocahontas Mining LLC* and in *Nextel WIP Leasing Corp.*, the Court, relying on its prior decisions in *Video Zone*, 267 Va. at 625, 594 S.E.2d at 923, *Tuomala v. Regent Univ.*, 252 Va. 368, 374, 477 S.E.2d 501, 505 (1996), *Galloway Corp. v. S.B. Ballard Constr.*, 250 Va. 493, 502, 464 S.E.2d 349, 355 (1995), and *Berry*, 225 Va. at 207, 300 S.E.2d at 796, explained that "[a]n ambiguity exists when [a] contract's language is of doubtful import, is susceptible of being understood in more than one way or of having more than one meaning, or refers to two or more things at the same time." The Court further instructed in both of these cases that the mere fact that the parties disagree about the meaning of the contract's terms is not evidence that the contract language is ambiguous, citing *Pocahontas Mining Ltd. Liab. Co. v. Jewell Ridge Coal Corp.*, 263 Va. 169, 173, 556 S.E.2d 796, 771 (2002), *Dominion Savings Bank v. Costello*, 257 Va. 413, 416, 512 S.E.2d 564, 566 (1999), *Galloway*, 250 Va. at 502, 464 S.E.2d at 354, and *Wilson*, 227 Va. at 187, 313 S.E.2d at 398, as support. In addition, in *Nextel WIP Leasing Corp.*, the Court, citing its prior opinion in *Salzi v. Virginia Farm Bureau Mut. Ins. Co.*, 263 Va. 52, 55, 556 S.E.2d 758, 760 (2002), specified that the alleged ambiguity, "if it exists, must appear on the face of the instrument itself."

. To determine whether disputed lease terms are ambiguous, a court relies on the usual, ordinary, and popular meaning of those terms: Citing its prior decisions in *Video Zone*, 267 Va. at 626, 594 S.E.2d at 924; *Haisfield v. Lape*, 264 Va. 632, 637, 570 S.E.2d 794, 796 (2002); and *Jewell Ridge Coal Corp.*, 263 Va. at 173, 556 S.E.2d at 772, the Court in *Pocahontas Mining LLC* specified that "[i]n determining whether disputed contractual terms are ambiguous," the Court would "consider the words employed by the parties in accordance with their usual, ordinary, and popular meaning." The Court made the same observation in *Nextel WIP Leasing Corp.*, again citing to *Jewell Ridge Coal Corp.*

. When conducting ambiguity analysis, a court must presume that lease terms and provisions are not superfluous and must give effect to all such terms and provisions whenever reasonable meaning can be assigned to them: Relying on its prior decisions in *City of Chesapeake v. States Self-Insurers Risk Retention Group, Inc.*, 271 Va. 574, 578, 628 S.E.2d 539, 541 (2006), and *Westmoreland-LG&E Partners*, 254 Va. at 11, 486 S.E.2d at 294, in *Pocahontas Mining LLC*, the Court recited the well-established principles of contract interpretation that "[n]o word or phrase employed in a contract will be treated as meaningless if a reasonable meaning can be assigned to it," and that "there is a presumption that the contracting parties have not used words needlessly."

. Significance of omitted lease terms when conducting ambiguity analysis: Citing *Bentley Funding Group*,

L.L.C. v. SK&R Group, L.L.C., 269 Va. 315, 330, 609 S.E.2d 49, 56 (2005) and *First Nat'l Bank v. Roy N. Ford Co.*, 219 Va. 942, 946, 252 S.E.2d 354, 357 (1979), the Court explained that "the omission of a particular term from a contract is evidence that the parties intended to exclude that term."

. A *de novo* standard also applies to the trial court's resolution of the issue whether lease terms are ambiguous: Citing *Virginia Elec. & Power Co. v. Northern Virginia Regional Park Authority*, 270 Va. 309, 315, 618 S.E.2d 323, 326 (2005), *Video Zone, Inc.*, 267 Va. at 625, 594 S.E.2d at 923, *Utsch v. Utsch*, 266 Va. 124, 129, 581 S.E.2d 507, 509 (2003), and *Eure*, 263 Va. at 631, 561 S.E.2d at 667, in *Pocahontas Mining LLC* the Court recited the well-settled rule that "[t]he question whether a contract is ambiguous presents an issue of law," and that as a result, on appeal, a *de novo* standard of review applies. Relying on both *Video Zone*, 267 Va. at 625, 594 S.E.2d at 923, and *Pyramid Development, L.L.C. v. D&J Assocs.*, 262 Va. 750, 754, 553 S.E.2d 725, 727 (2001), the Court further explained that under this standard of review, the Court "do[es] not accord any deference to the circuit court's resolution of th[e] question" of ambiguity because it is "afforded the same opportunity as the circuit court to interpret the terms of the parties' contract."

. Lease terms must be given their plain meaning if they are clear and unambiguous, and parol evidence should not be considered: In *Levisa Coal Co.*, the Court, relying on its prior decision in *Jewell Ridge Coal Corp.*, 263 Va. at 173, 556 S.E.2d at 771, explained that if the terms used in a lease were "clear and unambiguous," courts would be obligated to "give them their plain meaning." In *Pocahontas Mining LLC*, the Court, citing its prior decisions in *Virginia Elec. & Power Co.*, 270 Va. at 316, 618 S.E.2d at 326; *Langman*, 247 Va. at 498, 442 S.E.2d at 675; and *Trailsend Land Co. v. Virginia Holding Corp.*, 228 Va. 319, 325, 321 S.E.2d 667, 670 (1984), elaborated on this concept, specifying that "[w]hen the writing, considered as a whole, is clear, unambiguous, and explicit, a court asked to interpret such a document should look no further than the four corners of the instrument."

. If lease terms are found to be ambiguous, parol evidence may properly be considered in order to ascertain the intent of the parties and resolve the ambiguity: In *Nextel WIP Leasing Corp.*, the Court, relying on *Dart Drug Corp. v. Nicholakos*, 221 Va. 989, 277 S.E.2d 155 (1981), observed that "when a case involves the construction of covenants requiring strict construction and the provisions are ambiguous, 'the intention of the parties is the controlling factor' and extrinsic evidence is admissible to discern that intention." The Court based its observation on several of its prior decisions specifically approving the use of extrinsic evidence: *Ott v. L&J Holdings, LLC*, 275 Va. 182, 187, 654 S.E.2d 902, 905 (2008), *Prospect Dev. Co. v. Bershader*, 258 Va. 75, 84, 515 S.E.2d 291, 296 (1999), and *Cascades North Venture Ltd. P'ship v. PRC Inc.*, 249 Va. 574, 579, 457 S.E.2d 370, 373 (1995), and then cited several other cases as examples of circumstances warranting the consideration of extrinsic evidence to resolve ambiguous contract language in accordance with the intent of the parties: *Video Zone*, 267 Va. at 626, 594 S.E.2d at 924, *Tuomala*, 252 Va. at 374-375, 477 S.E.2d at 505, *Georgiades v. Biggs*, 197 Va. 630, 634, 90 S.E.2d 850, 854 (1956), *Young v. Schriner*, 190 Va. 374, 379, 57 S.E.2d 33, 35 (1950), *Shockey v. Westcott*, 189 Va. 381, 389, 53 S.E.2d 17, 20 (1949), and *Stewart-Warner Corp. v. Smithey*, 163 Va. 476, 487, 175 S.E. 882, 886 (1934).

. Where lease language is fairly susceptible of multiple interpretations due to ambiguity, such ambiguity is generally to be resolved in favor of the lessee. In *Nextel WIP Leasing Corp.*, the Court, relying on *Parrish v. Robertson*, 195 Va. 794, 800, 80 S.E.2d 407, 410-411 (1954), observed that "where uncertainties or ambiguities exist [in a lease], the tenant is favored by law" and that "the language of a lease which is fairly susceptible of two constructions is to be taken most [strongly] against the lessor." The Court reasoned that this was so because "the [lessor], having the power of providing expressly in his own favor, has neglected to do so" whenever an ambiguity exists, and also because of "the general principle that every man's grant is to be taken most strongly against himself."

. Lease restrictions are generally construed in favor of the lessee, such that any activity not expressly prohibited under the restriction will be permitted as long as it does not amount to waste or destruction of the leasehold. Relying on its prior opinion in *Oakwood Smokeless Coal Corp. v. Meadows*, 184 Va. 168, 177, 34 S.E.2d 392, 396 (1945), the Court observed in *Nextel WIP Leasing Corp.* that "[i]t has been stated as a general rule that where doubt exists as to the meaning of lease restrictions as to the use of property, such provisions are to be resolved in favor

of the lessee and against the lessor." The Court further observed that, consistent with this general rule, it had previously concluded in *Oakwood Smokeless Coal Corp.* that "[a] lessee of real property is entitled to exclusive use of the demised premises for any purpose not prohibited by the lease, not amounting to waste or destruction of the subject matter," and had similarly concluded in *Stonegap Colliery Co. v. Kelly*, 115 Va. 390, 394, 79 S.E. 341, 342 (1913) that "[a] covenant that premises shall be used by a lessee for a particular specified purpose does not impliedly forbid that [the premises] may be used for a similar lawful purpose which is not injurious to the landlord's rights, unless such other use is expressly forbidden."

Key Issue # 1 (*Levisa Coal Co.*): Is the interpretation of lease language and the extent of a lessee's rights under a lease limited by the scope of the property rights held by the lessor with respect to the leased property?

The Court answered this question in the affirmative in *Levisa Coal Co.*

In ascertaining whether the circuit court had misinterpreted the language of the 1956 mining lease allowing "any use of the leased premises which [the lessee coal company] may deem needful or convenient in carrying on its mining or other operations" as permitting the lessee to use the leasehold to support the mining operations conducted by its parent company, a direct competitor of Levisa Coal, on other lands, the Court recognized in *Levisa Coal Co.* that under *Clayborn v. Camilla Red Ash Coal Co.*, 128 Va. 383, 105 S.E. 117 (1920), the 1937 deed conveying the solid mineral estate of the Buchanan County parcels to Levisa Coal granted it only a "necessary incidental easement" for purposes of removing the coal and other minerals located on and under the surface of those parcels. Elaborating on the "necessary incidental easement" concept, the Court relied on its prior opinion in *Clayborn*, explaining that in that case, the Court had recognized that "a grantee of coal in place is the owner, not of an incorporeal right to mine and remove, but of a corporeal freehold estate in the coal, including the shell or containing chamber," and that as such owner, the grantee "has the absolute right, until all of the coal has been exhausted, to use the passages opened for its removal for any and all purposes whatsoever . . . so long as he operates and uses the passages with due regard to the rights of the surface owner." The Court also reaffirmed its ultimate holding in *Clayborn*: that a deed or lease transferring a coal estate or portion thereof is the grant of an estate determinable that ends when the coal is all removed, that "[t]he space [the coal] occupied reverts to the grantor by operation of law" when the estate determinable ends, and that the right to use the tunnels and shafts created by mining the coal does not extend to the support of mining operations on other lands, but only to the mining operations within the determinable estate. In addition, the Court repeated its conclusion, previously reached in *Clayborn*, that "[i]f the coal owner expects more" than the right to mine and remove the coal within his estate "he ought to stipulate for it" in the deed or lease. Regarding the question whether mine tunnels and shafts can be used to store water generated by mining operations, the Court, citing Daniel M. Barringer and John S. Adams, *The Law of Mines and Mining in the United States* 631 (1900), referred to the "long-established" principle in American mining law that "[t]he owner of a mine . . . may allow the water therein to flow in natural channels and percolations into an adjoining mine, but he may not, in absence of an easement or license to do so, discharge [water] by means of artificial drains into such adjoining mine" and determined that this principle "applies both to mines at different levels within the same subsurface area of a single tract of land as well as to mines on different tracts of land."

Based on the foregoing principles, the Court concluded in *Levisa Coal Co.* that it could "discern no practical distinction between supporting adjoining mining operations by using tunnels and shafts to transport coal, as in *Clayborn*, and the storing of wastewater from such operations in the voids, tunnels and shafts of an unrelated mine, as in this case." Accordingly, the Court explained that it was "of opinion that when the 1937 deed conveyed the solid mineral estate of the Buchanan County parcels to Levisa Coal, the parties to that deed contemplated only that the coal and other minerals would be mined from that estate, and that the deed conveyed only an incidental easement to use that portion of the parcels retained by the surface owner as was necessary to support such mining operations." The Court further pointed out that "[n]othing in the deed conveyed any right to use the voids, tunnels and shafts created below the surface for any purpose other than to support the mining operations on those parcels." Continuing, the Court explained that "[s]ince the 1937 deed conveyed no right [to Levisa Coal] to use any portion of the mineral estate to support mining operations on other lands, the 1956 [mining] lease could not have granted such right" to the lessee coal company. Further, the Court recognized that "[c]learly, [the lessee coal company] did not stipulate for such a use of the leasehold

in the 1956 [mining] lease," and specifically acknowledged that Levisa Coal could not have granted such rights "even if they had been sought" by the lessee coal company because it did not possess those rights as a result of the 1937 deed. As a result, the Court explained that the lessee coal company "simply lacks the authority to permit [its parent company] to store wastewater from other mining operations" in the mine on the leasehold that had been idled. Thus, the Court held in *Levisa Coal Co.* that the circuit court erred in ruling that the parent company had the right to store, with the permission of its subsidiary as the lessee under the 1956 Mining lease, wastewater generated by its mining activities on other property in the mine that the lessee had idled on the leasehold.

Key Issue # 2 (*Pocahontas Mining LLC*): Was the extent of the lessee's exclusivity ambiguous as to rights granted to it by the lease?

The Court answered this question in the negative in *Pocahontas Mining LLC*.

In analyzing the issue of ambiguity, the Court in *Pocahontas Mining LLC* focused on the following language, which it identified as the "granting clause" of the lease:

Lessor grants, leases and lets exclusively unto Lessee any and all rights it has to all of the coalseam gas . . . underlying [the property] together with any and all rights necessary or convenient to develop, produce, market and sell said coalseam gas including, but not limited to, the exclusive rights of exploring, drilling, producing, gathering, transporting, and selling the coalseam gas, the rights to construct and maintain all pipelines, tanks, structures, and utility lines that Lessee may deem necessary and convenient for the production and/or transportation of coalseam gas or other gas, whether or not owned, leased, or produced by Lessee, from this and other lands, whether or not owned or leased by Lessee

The Court then observed that "the language in the lease granting [the coalseam gas company] rights to construct and maintain pipelines does not limit Pocahontas' right to use the property for those purposes, except to require that Pocahontas permit [the coalseam gas company] to construct and maintain 'all pipelines, tanks, structures, and utility lines that [it] may deem necessary and convenient' for the production and transportation of the coalseam gas or other gas." Instead, the Court explained that "[t]he language at issue merely details [the] right [of the coalseam gas company] to erect pipelines and other facilities and to use those pipelines and facilities for the purposes described in the lease."

The Court further concluded that the language of the lease, as set out in the granting clause, "is not rendered ambiguous by the parties' use of the term 'exclusively,' which appears at the beginning of the disputed language." Rather, the Court explained that "[t]he parties' inclusion of this term merely clarified that Pocahontas granted exclusively to the coalseam gas company] all the rights to the coalseam gas underlying the property." In doing so, it specifically rejected the coalseam gas company's argument for a broader interpretation of the scope of the exclusivity of its rights under the lease. Specifically, the Court concluded that this "more expansive interpretation of the term 'exclusively' is unavailing, because acceptance of [that] position would impermissibly require us to treat as meaningless and redundant the lease's later designation of particular rights as 'exclusive.'" Elaborating on the reason for rejecting the coalseam gas company's "more expansive interpretation of the term 'exclusively,'" the Court explained that "[v]iewed in . . . context, the absence of a term denoting exclusivity in the description of [the coalseam gas company's] 'rights to construct and maintain all pipelines' is significant," because, under the principle the Court had identified in *Bentley Funding Group*, 269 Va. at 330, 609 S.E.2d at 57 and *First Nat'l Bank*, 219 Va. at 946, 252 S.E.2d at 357, "by omitting any reference to an exclusive right in addressing the subject of pipelines on the leased property, the parties expressed their intent that such rights of [the coalseam gas company] would not be exclusive."

The Court's ambiguity analysis also focused on the following, which it identified as being "Pocahontas' express reservation of rights" in the lease:

Except as granted and leased herein, there is excepted and reserved to [Pocahontas] the entire ownership and control of the lands included herein and the oil, gas, coal, stone, sand, water, timber, and other minerals and products

therein and thereon, with the right to use and dispose of the same for all purposes other than those for which this Lease is made except as such ownership and control may be leased to other parties by other instruments.

The Court explained that the foregoing "express reservation of rights" likewise supported a rejection of the coalseam gas company's "more expansive interpretation of the term 'exclusively,'" for two primary reasons. First, the Court reasoned that such an interpretation "would render inoperative Pocahontas' reservation of rights to the property for such purposes as the development of oil and non-coalseam gas, which would have to be transported from the property through pipelines." Second, the Court observed that under this interpretation, "Pocahontas would be precluded from engaging in any activity that was 'necessary or convenient' for [the coalseam gas company]'s utilization of its interest in the leasehold property, irrespective whether Pocahontas' activities actually caused the coalseam gas company to suffer any inconvenience or other difficulty." According to the Court, the coalseam gas company's expansive interpretation of "exclusively" would "effect a sweeping evisceration of Pocahontas' other production rights in the property, in contravention of Pocahontas' express reservation of rights in the lease."

The Court resolved the ambiguity analysis by concluding that "the disputed lease provisions are unambiguous," and held that "[b]y selectively identifying certain rights as 'exclusive,' while omitting any reference to the term 'exclusive' in describing other rights, the lease language signifies the parties' clear intention that only some, rather than all, the stated rights are exclusively granted to" the coalseam gas company. Specifically, the Court found that "[t]he lease gives [the coalseam gas company] exclusive rights to the coalseam gas estate, including the exclusive rights of exploration, drilling, production, gathering, transportation, and sale of the coalseam gas," and that "[t]he lease also grants to [it] non-exclusive rights, including the right to construct and maintain pipelines and other facilities necessary and convenient for the production and transportation of the coalseam gas, and of other gas from whatever source." Further, the Court found that "the clear purpose of the lease was to allow [the coalseam gas company] to produce, transport, and sell the coalseam gas obtained from the property, and to transport 'other gas' from whatever source over Pocahontas' property." Accordingly, the Court ultimately held that "[t]he disputed lease provisions protect [the coalseam gas company's] rights to take such actions as are necessary and convenient to conduct these activities, but do not permit [it] to prevent other uses of the land that do not affect [its] exercise of its stated lease rights."

Key Issue #3 (*Nextel WIP Leasing Corp.*): Is the lease ambiguous on its face concerning the number of telecommunications towers that can be constructed on the leasehold and, if so, does parol evidence indicate that the lease should be interpreted in a manner favoring the lessees?

The Court answered the first of these questions in the affirmative in *Nextel WIP Leasing Corp.*, but ultimately concluded in that case that parol evidence did not support the interpretation of the lease favored by the lessees.

In analyzing the issue of ambiguity, the Court began by examining the language of the following three paragraphs of the lease concerning the intended use of the leased premises, the lessor's representations and warranties, and leasehold improvements, respectively identified as paragraphs 10, 14, and 17(a):

10. Use. The premises may be used by Lessee for the transmission and receipt of wireless communication signals in any and all frequencies and the construction and maintenance of **towers**, antennas, or buildings, and related facilities and activities ("Intended Use"). Lessor agrees to cooperate with Lessee in obtaining, at Lessee's expense, all licenses and permits required for Lessee's use of the Premises (the "Governmental Approvals"). Lessee may construct additional improvements, demolish and reconstruct improvements, or restore replace and reconfigure improvements at any time during the Initial Term or any Renewal Term of this Lease. [Emphasis added.]

14. Lessor's Representations and Warranties. Lessor represents and warrants that (i) Lessee's Intended Use of the Premises as a site for the transmission and receipt of wireless communication signals; for the construction and maintenance of **towers**, antennas or buildings; and related facilities is not prohibited by any covenants, restrictions, reciprocal easements, servitudes, subdivision rules or regulations. [Emphasis added.]

17. Improvements; Utilities; Access. (a) Lessee shall have the right, at Lessee's sole cost and expense, to erect and maintain on the Premises improvements, personal property and facilities, including without limitation, **one (1) tower**, a structural tower base, radio transmitting and receiving antennas, communications equipment, an equipment cabinet or shelter and related facilities. [Emphasis added.]

In doing so, the Court acknowledged that the lessee and its assignee each argued that "paragraphs 10 and 14, which permit 'towers,' [we]re consistent with and not contradictory of paragraph 17(a), which permits 'improvements . . . including without limitation, one (1) tower.'" The Court further acknowledged that the lessee and its assignee viewed such language as "indicating . . . that the lease provides the lessee with 'the right to construct a minimum of one tower on the [p]remises,'" and as providing "no basis to either ascribe ambiguity to the provision or construe the provision as limiting use of the leased property to the construction of one tower only." Finally, the Court acknowledged that the lessee and its assignee each also argued that "the word 'including,' found in paragraph 17(a), implies that the list following is not exhaustive and not exclusive," and that "the provision 'including without limitation, one (1) tower' unambiguously permits the erection of more than one tower on the leased premises."

Notwithstanding these acknowledgments, the Court ultimately rejected the arguments advanced by the lessee and its assignee. The Court began by indicating that it was "willing to adopt" the definition of the term "includes" desired by the lessee and its assignee, who asserted, based on *Federal Election Comm'n v. Mass. Citizens for Life, Inc.*, 769 F.2d 13, 17 (1st Cir. 1985) and Black's Law Dictionary 777 (8th ed. 2004) that it was "'usually a term of enlargement, and not of limitation'" and "'conveys the conclusion that there are other items includable, though not specifically enumerated.'" However, the Court quickly pointed out, after making this concession, that "[i]n the context in which it appears, the 'including without limitation' language means that there could be no limitation upon the maintenance, use, or improvement of the one tower listed in paragraph 17(a)," and that this language indicated that there could not be "any limitation upon the addition of some different item not specifically enumerated that might be necessary or convenient to the erection, maintenance, use, or improvement of that one tower." The Court also emphasized that "the 'including without limitation' language certainly does not require [the Court] to ignore that the 'usual, ordinary, and popular meaning' of the word 'one,' appearing in paragraph 17(a), is 'one,' not 'two.'" The Court then continued by pointing out that under *Berry*, 225 Va. at 208, 300 S.E.2d at 796, it was required to examine and consider the lease as a whole, and that "[i]n this approach, paragraphs 10 and 14 [of the lease] come into play." The Court then observed that "[p]aragraph 17(a) may be understood as permitting only one tower while paragraphs 10 and 14 may be understood as permitting more than one." Accordingly, the Court found that "there is an unmistakable ambiguity in the provisions of the lease agreement."

Given the finding of ambiguity, the Court explained that "[t]he question then becomes how the ambiguity should be resolved." In addressing this issue, the Court began by addressing the argument of the lessee and its assignee that instead of considering parol evidence, the trial court should have considered whether, under "settled rules of interpretation," there was a "genuine uncertainty as to which [of] two or more possible meanings represents the contracting parties' true intent" and that, "if the words chosen by the parties have an ordinary, plain meaning . . . parol evidence is inadmissible." Rejecting this argument, the Court explained that "it is impossible to ascertain from a consideration of the lease agreement as a whole which of the two possible meanings represents the true intent of the parties." As a result, under the numerous prior cases authorizing the use of parol evidence to resolve contractual ambiguities, the Court concluded that "the trial court did not err in admitting parol evidence" to ascertain the intent of the parties as to the issue of whether the parties intended that the lease would permit the construction of more than one telecommunications tower on the leased premises. Ultimately, after examining parol evidence consisting of testimony of the lessor and lessee concerning their negotiations regarding the lease, their exchange of draft agreements prior to finalizing the version of the lease agreement that was ultimately executed, and edits made and not made therein, and representations made by the lessee concerning what use it planned to make of the leased property, the Court concluded that this evidence did not support an interpretation of the lease as permitting more than one telecommunications tower to be constructed on the property:

[S]tandard or not, Nextel kept the "one (1) tower" provision in Exhibit B, the final version that it prepared of the

lease agreement and that was signed by the parties. . . . [T]here is [also] the evidence of Nextel's first contact with the [lessors], when its representative told them Nextel was interested in their mountain for "a," meaning one, "tower[;]" there is the evidence that the representatives [of the parties] negotiated for only one tower[;] and there is the evidence of the representation made by a Nextel representative that only one tower would be built, all uncontradicted and all showing what was in the "heads" not only of the lessors but of the lessee's personnel as well. It is this evidence, coupled with the evidence of Nextel's retention of the "one (1) tower" language in the lease agreement, that truly "represents what the parties bargained for and agreed to." [Thus, w]e hold that the circuit court did not err in holding that the lease agreement "permits the construction of one communication tower, and only one communication tower."

Importance of rulings. Considered together, the Court's opinions in *Levisa Coal Co.*, *Pocahontas Mining LLC*, and *Nextel WIP Leasing Corp.* provide a wealth of rules, supported by numerous cases and other authorities, detailing how a court will ascertain the specific rights granted by a lease, determine whether lease language is ambiguous, and resolve any such ambiguities. Accordingly, these recent decisions provide a useful starting point for both lessors and lessees, as well as their counsel, to use in order to evaluate the relative strengths and weaknesses of their clients' legal positions as to the issue of whether a particular activity is or is not permitted under the language the parties have used in their lease. However, the rulings ultimately reached in each of these three cases also provide significant instructional value in their own right. *Levisa Coal Co.* makes it clear that an overarching issue to be determined, whenever a dispute arises as to whether or not a lessee is permitted to make use of the leasehold for a particular purpose or to engage in a particular activity, is whether the lessor possessed the right to either permit that use to be made of the leasehold or to permit that activity to be conducted. This is so because, as the Court teaches in *Levisa Coal Co.*, if a lessor does not possess the right, then it cannot be lawfully granted to the lessee, regardless of any interpretation of lease language advocated by the lessee. Thus, where the lessor has less than a fee simple estate in the leased property, lessees would be well-advised to ascertain the extent of the lessor's rights in that property, so as to avoid engaging in an activity or making a use of the leased premises that does not clearly fall within the "bundle of rights" that the lessor is capable of conferring on the lessee via the language in their lease. *Pocahontas Mining LLC* is similarly important, in that the case clearly indicates that lease language that may, at first glance, appear to confer an expansive set of "exclusive" rights on the lessee may ultimately not end up conferring as many "exclusive" rights as initially thought due to the omission of this term in the enumeration of specific rights granted to the lessee. Further, as *Pocahontas Mining LLC* teaches, this is particularly so when the lease contains a separate provision reserving certain rights to the lessor that concern the same or similar subject matter as the rights that the lessee contends were exclusively granted to it, because in that event, the rules that the entire lease must be considered as a whole and that no lease provision is to be evaluated in isolation will significantly impact the "exclusivity" analysis. Finally, *Nextel WIP Leasing Corp.* is also significant, in that it clearly indicates that parol evidence concerning prior negotiations leading up to the lease agreement can have a decisive impact upon the interpretation of ambiguous lease terms. Accordingly, under *Nextel WIP Leasing Corp.*, prior written drafts of the final lease agreement containing editorial marks, proposed interlineated terms, and proposed deletions, if available, can go far to establishing the validity or invalidity of each party's respective positions regarding the issues of whether the language appearing on the face of a lease permits or prohibits a particular use of leased property, or permits or prohibits a particular activity with respect thereto. Of course, parties may seek to preclude later use of such parol evidence by carefully drafting their lease so as to eliminate any internal inconsistencies in the lease, such as the use of "towers" in paragraphs 10 and 14 of the lease at issue in *Nextel WIP Leasing Corp.*, but the use of "one (1) tower" in paragraph 17(a) of that same lease.

CVirginia Cross-References. For further analysis of the topics of Virginia law addressed herein, please consult the following sources:

Regarding the general rules of contract interpretation, see *Michie's Jurisprudence of Virginia & West Virginia*, Contracts §§ 40-53 (2007).

Regarding the use of parol evidence, see Charles E. Friend and Kent Sinclair, *Friend's Virginia Pleading and Practice* § 24.15 (Parol Evidence Rule) (2d ed. 2007); see also *Michie's Jurisprudence of Virginia & West Virginia*, Evidence §§ 130-164 (Parol Evidence) (2007).

Regarding leases generally, see Michie's Jurisprudence of Virginia & West Virginia, Landlord and Tenant §§ 7-10 (2007).

Regarding the use of leased premises, see Michie's Jurisprudence of Virginia & West Virginia, Landlord and Tenant §§ 32-33 (2007).

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30 of 79 DOCUMENTS

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Real Estate Laws and Anticompetitive Conduct

2008 Emerging Issues 100

Real Estate Laws and Anticompetitive Conduct

By Publisher's Editorial Staff 2008

December 18, 2008

SUMMARY: This Emerging Issue Analysis examines the laws and practices the Antitrust Division of the United States Department of Justice (DOJ) considers anticompetitive, it discuss the DOJ's position with respect to these laws and analyzes the lawsuits filed by the DOJ in response to the legislation.

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ARTICLE: Introduction

The recent expansion of state-wide and nationwide residential real estate broker services, which primarily resulted from the explosive proliferation of the internet, has provided residential home buyers and sellers with the realization that home purchase or sale expenses and commissions charged by traditional real estate brokers can be substantially reduced. Obviously, the reduced commissions and expenses result in more money to the consumer, and greater profitability in the sale of a residence. A significant reduction in "traditional" commissions may also result in increased sales, and it may have a profound impact on the downpayment available to a seller for the purchase of a new home.

In spite of the technological advances in real estate marketing techniques, existing laws and regulations in many states, and old-school notions of close-knit and self-serving marketing by some brokers, have created a barrier to a more competitive marketplace for residential home sale transactions.

In response to state legislation protecting traditional services from competition, and as a result of a number of private complaints and lawsuits filed against real estate associations and marketing groups, the Antitrust Division of the United States Department of Justice (DOJ) launched a website on October 10, 2007, http://www.usdoj.gov/atr/public/real_estate/index.htm. The website explores the advantages of free competition in the residential real estate industry. In addition, the DOJ has filed several lawsuits against real estate associations and marketing services in an attempt to eliminate the barriers it believes are an impediment to a free marketplace in the residential real estate industry.

The purpose of this emerging issue commentary is to briefly examine the laws and practices the DOJ considers

anticompetitive, discuss the DOJ's position with respect to these laws and analyze the lawsuits filed by the DOJ in response to the legislation. This commentary is not intended to provide the reader with a detailed background on traditional brokerage services or multiple listing services. For a complete history on those topics, the reader is directed to 15-84C *Powell on Real Property* § 84C.01 through 15-84C *Powell on Real Property* § 84C.07 and 10A-8 Real Estate Brokerage Law and Practice § 8.01 through 10A-8 Real Estate Brokerage Law and Practice § 8.05.

Anticompetitive Practices In Residential Real Estate Transactions

Commission Price-Fixing

A broker's commission and additional service costs are required to be negotiable. Agreements between real estate brokers to fix commission rates are 'per se' violations of § 1 of the Sherman Act. Prior to the 1970's, it was not uncommon for real estate trade associations to publish 'recommended' commission schedules for their members' use. 10A-8 Real Estate Brokerage Law and Practice § 8.04. The United States Supreme Court in 1975 flatly rejected this conventional wisdom in *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (U.S. 1975). In *Goldfarb*, the Supreme Court held that the "recommended" fee schedule at issue was *per se* illegal price-fixing.

Multiple Listing Service and Restraint of Trade Issues

Another real estate tool that tended to stifle the competition between member and non-member brokerage houses involved the use of the MLS. The MLS is a service arrangement wherein the participating members of a real estate board in a given geographical area posted their listings to the MLS. Other participating members were granted the right to access the MLS for clients, to the exclusion of non-members brokers and agents.

Many licensed brokers and salespeople who were not real estate board members were denied use of the MLS, leaving them at a considerable competitive disadvantage in light of the power and importance of multiple listing services. 15-84C *Powell on Real Property* § 84C.03; see *Comment, Exclusion of Real Estate Multiple Listing Service as Antitrust Violations*, 14 Cal. W. L. Rev. 300, 302 (1978). This disadvantage was very substantial for brokers licensed in the same state as the MLS broker, but who represented a client who wanted to purchase a residence in the area covered by the MLS.

In the 1970s, a number of lawsuits challenged restrictions on MLS membership as illegal restraints of trade. At that time, American jurisprudence was split on the legality of restrictions on MLS membership; a few states held that the restrictions were illegal, see, e.g., *Collins v. Main Line Bd. of Realtors*, 452 Pa. 342 (Pa. 1973), and some states upheld the restrictions, see, e.g., *Collins v. Main Line Bd. of Realtors*, 452 Pa. 342 (Pa. 1973). Federal cases that interpreted the Sherman Antitrust Act upheld reasonable restrictions on access to an MLS. *Souza v. Estate of Bishop*, 821 F.2d 1332 (9th Cir. 1987).

Anticompetitive Legislation Affecting Residential Real Estate Transactions

Legislation That Prohibits Rebates

Several states have statutes that prohibit real estate brokers from offering commission rebates to clients for the use of the broker's services. The offering of rebates is typically used as a marketing tool to acquire listings from homeowners. The majority of states do not prohibit a rebate. However, Alabama, Alaska, Iowa (prohibits rebates when the consumers use the services of two or more real estate brokers during a transaction), Kansas, Louisiana, Missouri,

Mississippi, Montana, North Dakota, Oklahoma, New Jersey and Tennessee currently bar a real estate broker from offering a rebate to a client. The legislation that bars the rebate scheme is typically based on the fact that the client/homeowner is not licensed as a real estate broker or agent, and therefore not entitled to a share in the commission. The prohibition against using this marketing tool is easily circumvented by the broker who offers to list a house for a lesser commission percentage that she would normally charge. The outcome to the client is the same, but the listing broker receives less on the sale.

Legislation That Requires Lawyers To Close Residential Real Estate Transactions

In past years, lawyers handled the bulk of the paperwork in a residential real estate transaction. In fact, it was counsel who was hired to review the abstract of title and furnish an opinion letter as to the marketability of title. Obviously, the attorney's fee was an integral part of the cost of the transaction. Today, the title commitment and resulting policy have replaced the abstract and opinion in all but a handful of states.

Likewise, the vast majority of residential real estate transactions are handled by the real estate broker. A client may, but is not required, to hire an attorney to assist with the transaction. In some states, Kansas, Kentucky, Virginia, Rhode Island, North Carolina, Indiana and Georgia, a lawyer is required by law to handle and/or close the transaction. See O.C.G.A. § 15-19-50. In some cases, the lawyer is the only person who can abstract and give an opinion on title.

Legislation That Protects Traditional Brokerage Services

At the present time, nine states have statutes that limit the use of full-service discount and/or flat-fee brokers, namely, Alabama, Iowa, Idaho, Illinois, Indiana, Missouri, Texas, Utah and Washington. These statutes require the licensed real estate broker to perform nearly all of the services a full-service broker performed for a client. The broker's duties in these states are mandatory, and usually, the statutes provide that the broker may charge a separate fee or commission for each service provided to the client. See generally Idaho Code § 54-2087.

The result of this type of legislation is to limit a client's choice in selling his home. The client must accept all of the services the broker offers, and also pay the price for the services. The commissions and costs must be factored into the home-selling equation. There are relatively few outs for the client.

United States Department of Justice Response to Anticompetitive Practices and Legislation

Litigation

The United States Department of Justice, through its Antitrust Division, (DOJ) has taken the position that the legislation and practices discussed herein are anticompetitive measures that stifle the competition and cost consumers millions of dollars each year. The DOJ considers the practices and legislation "barriers to a more competitive (residential real estate) brokerage market." In response to the legislation and practices mentioned herein, the DOJ has filed lawsuits challenging state legislation it considers anticompetitive. Most notable of these lawsuits are: 1) *United States v. Nat'l Ass'n of Realtors*, 2006 U.S. Dist. LEXIS 86963 (D. Ill. 2006); and 2) *United States v. Kentucky Real Estate Commission*, 3:05cv188 (WD Ky.).

In *National Association of Realtors* (NAR), the DOJ filed an antitrust action against the NAR pursuant to § 1 of the Sherman Act, 15 USCS § 1. The DOJ contended that a number of NAR member brokers began creating password-protected websites that enabled potential home buyers, once they had registered as customers of the broker, to search the multiple listing service (MLS) database themselves and to obtain responsive MLS listings over the Internet. These websites came to be known as virtual office websites or VOWs, and brokers who operated primarily or exclusively through a VOW came to be known as VOW-operating brokers. The VOW brokers successfully used the

websites to reduce their costs, and in turn, passed the savings on to their clients by offering reduced fees and commissions for residential real estate services. The DOJ alleged that the VOW brokers presented a competitive challenge to brokers who provided listings to their customers only or principally by traditional, non-Internet methods.

The NAR, however, adopted an obligatory and enforceable policy governing the use of MLS data in connection with Internet brokerage services offered by MLS participants. The policy contained an opt-out provision that forbade any broker participating in an MLS from conveying a listing to his or her customers via the Internet without the permission of the listing broker. It also contained an anti-referral provision that precluded VOW brokers from referring their customers to any other entity for a fee. On the other hand, no NAR rule limited referrals for a fee by brokers who did not convey MLS listings to customers over the Internet. Although modified by the NAR after it received notification of the pending lawsuit from the DOJ, the existing policy, according to the DOJ, is not compatible with free market principles.

The DOJ alleged in its complaint that the (modified) NAR policy was anticompetitive and that it stifled the competition in the nationwide residential real estate markets. The DOJ maintained that the original and modified policies constituted a contract, combination, or conspiracy by and between NAR and its members which unreasonably restrained competition in brokerage service markets throughout the United States to the detriment of American consumers. The lawsuit is pending; a district court judge denied a motion by the NAR to dismiss the complaint. See *United States v. Nat'l Ass'n of Realtors*, 2006 U.S. Dist. LEXIS 86963 (D. Ill. 2006).

In *Kentucky Real Estate Commission*, the DOJ filed an antitrust action against the Commission for alleged violations of § 1 of the Sherman Act, 15 USCS § 1. The DOJ contended that the Commission, in adopting a "rebate ban" pursuant to 201 Kan. Admin. Regs. 1:011 and 201 Kan Admin. Regs. 11:121, enabled licensee brokers to raise, fix, peg or stabilize prices at which the brokers were compensated. The DOJ maintained that the rebate ban deprived consumers of the benefits of price competition among brokers in providing real estate services in Kentucky. The DOJ claimed that the rebate ban made it more difficult for consumers of real estate brokerage services in Kentucky to obtain lower prices for those services.

The case was concluded in November 2005 through the entry of a consent judgment. In the judgment, the Commission was, inter alia, enjoined from: 1) entering into, continuing, maintaining, or renewing any agreement, contract, or regulation to fix, establish, raise, stabilize, suppress, eliminate, regulate, or maintain the level of commissions, discounts, rebates, Inducements, or the licensee price; 2) prohibiting, restricting, impeding, or discouraging any licensee from price advertising or from offering any licensee price, discounts, rebates, or inducements; 3) disciplining any license for offering discounts or rebates to clients; and 4) enforcing the rebate ban. In addition, the Commission was required to publish a statement in its periodic newsletter advising all licensees that it agreed to stop enforcing regulations that restricted the use and advertisement of rebates, inducements or discounts, and it was also required for a period of three years to give all new licensees a copy of the consent judgment.

Investigations

The DOJ has, over the past several years, taken a very active, aggressive position with regard to any law, administrative rule or policy it determines to be anticompetitive. In that regard, it has conducted investigations in a number of states after receiving complaints, and it has issued press releases when legislative or administrative bodies relent and modify their existing or proposed statutes or administrative regulations.

The DOJ also investigated rebate bans by the South Dakota Real Estate Commission, the West Virginia Real Estate Commission, and the Tennessee Real Estate Commission. In response to these investigations, the South Dakota and West Virginia Real Estate Commissions rescinded their regulations prohibiting rebates, thereby enabling consumers in those states to receive more benefits of competition. The Tennessee Real Estate Commission voted to suspend its

rules and is in the process of rescinding them entirely.

In order to inform the general public of its position regarding anticompetitive residential real estate practices and laws, the DOJ launched a website in October 2007: http://www.usdoj.gov/atr/public/real_estate/index.htm. The website contains links to its enforcement efforts over the past several years. In addition, the Federal Trade Commission (FTC), a DOJ ally in antitrust matters and a frequent plaintiff in Sherman Act lawsuits, published an extensive report entitled *Competition in the Real Estate Brokerage Industry: A Report by the Federal Trade Commission and U.S. Department of Justice*. See 70 FR 53362 for a source document with additional hyperlinks.

Conclusion

The residential real estate brokerage industry has evolved over the past several decades from closed groups or associations of geographically centered brokerage houses into an industry that literally has no geographical limitations. Notwithstanding this expansion, a crucial issue involved with home selling or buying success for the broker and the client is the level of cooperation that brokers are willing to have with one another.

As noted by the DOJ and FTC, "brokers may be deterred from discounting if cooperating brokers threaten to concentrate their efforts or steer buyers toward transactions for which higher commissions are available." *Competition in the Real Estate Brokerage Industry: A report by the Federal Trade Commission and U.S. Department of Justice*, April 2007 (available at http://www.usdoj.gov/atr/public/real_estate/workshop_reports.htm). A consumer's opportunity to save money in a real estate transaction can be thwarted if two or more brokers are involved and at least one brokers refuses to cooperate. In addition, a brokerage firm that solicits listings by offering lower commissions may find itself disadvantaged since agents from other firms may prefer to concentrate their efforts where higher commissions are available. This tendency may be reinforced by boycotts or other discriminatory practices.

With these issues in mind, it would appear beneficial for the consumer to have the strong arm of government on her side to focus its energy on discovering, investigating and eliminating anticompetitive practices and legislation in the residential real estate industry.

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31 of 79 DOCUMENTS

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Sommer on Foreclosures: Bankruptcy Issues

2008 Emerging Issues 2976

Henry J. Sommer on the Mortgage Foreclosure Crisis

By Henry J. Sommer

October 3, 2008

SUMMARY: Hundreds of thousands of homeowners have been affected by the mortgage foreclosure crisis. Henry J. Sommer, editor-in-chief of *Collier on Bankruptcy*, describes how for many of these borrowers, the current bankruptcy system offers little help. Rather, the best hope for relief lies in an amendment to the Bankruptcy Code.

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ARTICLE: Recent economic conditions have taken a toll on hundreds of thousands of homeowners who are facing foreclosure of their subprime loans. In many cases, Chapter 13 of the Bankruptcy Code offers little relief to such borrowers, and loan modification outside of bankruptcy is generally difficult to obtain. The most promising alternative is to amend the Bankruptcy Code to allow modification of a loan secured only by real estate that is the debtors primary residence.

Mortgage Foreclosure Crisis Poses New Challenges for Bankruptcy System

The recent increases in mortgage foreclosures have led to bankruptcy issues for a variety of groups. Many mortgage companies, especially those heavily involved in the subprime market, have filed chapter 11 cases or are potential chapter 11 candidates. As the real estate bubble bursts and housing prices drop, due in part to a glut of foreclosed properties on the market, other entities in the housing arena may also be caught up in the downturn. And, of course, there are hundreds of thousands of homeowner and perhaps more who are facing foreclosure as their adjustable rate mortgage (ARM) payments rise beyond their teaser rates to levels that are unaffordable. The Center for Responsible Lending has estimated that as many as 2.2 million homeowners have faced or will face foreclosure of their subprime loans. n1 While refinancing once seemed a way out for such homeowners with exploding ARMs, the fact that they have no equity due to stagnant or falling home values will eliminate that option for most.

Chapter 13 bankruptcy has traditionally been an oft-chosen remedy for debtors facing mortgage foreclosure. Typically, a debtor cures a mortgage default under Code section 1322(b)(5), maintaining current payments while catching up on arrears over three to five years. The right to cure a default has saved hundreds of thousands of homes for debtors who fell behind on their mortgages due to unemployment or other income interruptions, or due to unexpected expenses. In a small number of cases, in which a second mortgage has been taken that is totally unsecured, either because it was unsecured at the time of the loan or as a result of declining home value, chapter 13 also affords the right

to strip off the totally unsecured loan. [*Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2003); *Lane v. Western Interstate Bancorp (In re Lane)*, 280 F.3d 663 (6th Cir. 2002); *Pond v. Farm Specialist Realty (In re Pond)*, 252 F.3d 122 (2d Cir. 2001); *American Gen. Fin., Inc. v. Dickerson (In re Dickerson)*, 222 F.3d 924 (11th Cir. 2000); *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357 (11th Cir. 2000); *Bartee v. Tara Colony Homeowners Assn (In re Bartee)*, 212 F.3d 277 (5th Cir. 2000); *McDonald v. Master Fin., Inc. (In re McDonald)*, 205 F.3d 606 (3d Cir. 2000).] And with certain short-term loans, including those with balloon payments coming due within a few years, the debtor has the right to modify the loan, reducing the principal to the value of the property and reducing the interest rate in many cases.

However, for most homeowners facing foreclosure of subprime mortgages, these remedies may not be available. Many were qualified for their mortgages based solely on their credit scores and with no consideration of their ability to pay, or at best consideration only of their ability to pay the initial low teaser rate. To the extent these homeowners cannot pay the monthly payment once it has exploded to the full indexed rate, they cannot maintain their current payments, much less make payments towards arrears, in a chapter 13 plan to cure a default. And they are prohibited from modifying their mortgages by Code section 1322(b)(2), which, with exceptions noted above, generally precludes a chapter 13 debtor from modifying a secured claim secured only by real estate that is the debtors principal residence. [See generally *Collier on Bankruptcy*, 15th edition revised, 1322.06 (Matthew Bender).]

Loan Modification Outside of Bankruptcy

Another alternative for homeowners is loan modification, sometimes offered by mortgage companies to selected borrowers. Loan modification is similar to the modification that can take place with respect to most secured debts in chapter 13. The principal may be reduced, the interest rate may be reduced, and the loan may be converted from an adjustable rate mortgage to a fixed rate mortgage. A number of lenders have announced their intentions to work with borrowers to prevent foreclosures, in which the lenders are guaranteed to lose money, by modifying their mortgages. Regulatory agencies have encouraged mortgage lenders to work with borrowers to prevent foreclosures through loan modifications. [See Statement on Working with Mortgage Borrowers, available at www.federalreserve.gov.]

However, in practice, homeowners have found it difficult to obtain modifications of their loans. The process is cumbersome and involves large amounts of paperwork. Ultimately, it is solely in the lenders discretion to grant the modification. And while the homeowner is engaged in the process, often lulled into a false sense of security by the hope of modification, the foreclosure proceeds apace. Only when a sale is imminent does it become apparent that the modification will not occur. Thus, in reality, very few homeowners have obtained loan modifications from lenders. While the lenders blame the homeowners for not contacting them, the experience of those who have contacted the lenders indicates that this is not the primary problem. In addition, many loan servicers have refused to offer loan modifications because they believe such modifications are not permitted by the securitization trusts holding the loans. If loan modifications were offered more widely, more readily, and more easily, many more borrowers would seek them and they could perhaps provide significant assistance to homeowners facing foreclosure.

Proposed Amendment to the Bankruptcy Code

An alternative to the lenders voluntary loan modifications has been offered by a coalition of consumer groups, led by the Consumer Federation of America, the Center for Responsible Lending, the National Consumer Law Center, and the National Association of Consumer Bankruptcy Attorneys. These groups have proposed amendments to the Bankruptcy Code that, in essence, would require the modifications that are now subject to lenders whims.

The heart of these amendments is a change in the longstanding prohibition in section 1322(b)(2) against chapter 13 debtors modifying most loans secured only by a security interest in real estate that is the debtors principal residence. Under the proposal, chapter 13 debtors could reduce the principal debt to the value of the collateral, convert adjustable

rate mortgages to fixed rate mortgages at a reasonable interest rate, and reamortize the debt over 30 years. (The full proposal is available on the Web site of the National Association of Consumer Bankruptcy Attorneys.)

Such terms are similar to those offered to a few fortunate homeowners through voluntary loan modifications, but the amendment would make the terms obtainable as of right provided that the debtor could comply with the various requirements of chapter 13. As opposed to various bail-out plans also being proposed to deal with the foreclosure crisis, this proposal would not require government funds and would not reward those who made questionable loans. It also fits within a well-established structure—chapter 13—and would be facilitated by bankruptcy courts, trustees, and attorneys familiar with the problems of foreclosure and debt. Whether the proposal passes may depend upon the ultimate extent of the foreclosure crisis and whether lesser Band-aid approaches are sufficient to create the appearance that Congress and the regulatory agencies have addressed the crisis.

Return to Text

n1 Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 16, Table 6, available at <http://www.responsiblelending.org>; Center For Responsible Lending, *Subprime Lending: A Net Drain on Homeownership*, CRL Issue Paper No. 14 (Mar. 27, 2007) at 3, Table 2, available at <http://www.responsiblelending.org> (updating the findings of *Losing Ground* to reflect data for the fourth quarter of 2006).

RELATED LINKS: To access more articles on the subprime lending crisis, search the

- Mega News, Subprime Mortgages file on lexis.com.

For information on mortgage fraud legislation, see

- Real Estate Financing, ch. 5A (Matthew Bender).

For additional information on mortgage foreclosures, see

- Powell on Real Property, ch. 37 (Matthew Bender);
- and Bergman on New York Mortgage Foreclosures, ch. 2 (Matthew Bender).

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32 of 79 DOCUMENTS

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Current Trends And Issues In The Commercial Mortgage Market

2008 Emerging Issues 75

Current Trends And Issues In The Commercial Mortgage Market

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary notes some highlights and trends in the commercial real estate market and points to the reactions by federal regulators and lawmakers. Also addressed are the practitioner's role in the commercial real estate transaction, the impact of the subprime loan crisis on the commercial mortgage market, current commercial mortgage market lending practices and forecasts for 2008.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

The hot residential real estate market of recent years went hand in glove with the proliferation of subprime mortgage lending, bringing home ownership to those who could not access traditional mortgage products, and fueling the economy; new homes were constructed and sold, existing owners traded up or tapped the ever-increasing equity in their homes, commonly with debit cards tied to a home equity line of credit. Institutional investors purchased and securitized subprime loans. The commercial real estate mortgage market has also thrived in recent years, with \$300 billion in commercial loan originations in the United States in 2006. H. Lee Murphy, *Growth Amid a Downturn*, National Real Estate Investor, Dec. 1, 2007, p. 53.

The cooling of the residential real estate market has been equally dramatic; housing sales have slowed, and time frames for market times and closings are back to being measured in months and not days, lending has been tightened, and with rising foreclosure rates as millions of adjustable rate subprime mortgages have started to reset, subprime lenders are filing for bankruptcy. Rate cuts by the Federal Reserve quickly followed action by the Bush Administration for an agreement with lenders for a rate freeze on some subprime mortgages.

Cycles and timing are inherent in the real estate industry. This commentary will highlight several of the current conditions and trends affecting the commercial real estate mortgage market, and will address issues which are likely to be of increased emphasis and interest in the practitioner's representation of his commercial real estate clients. Commentary can be found from successful real estate investors that rewards are to be found, regardless of the phase of the real estate market's cycle, and the investor's practitioner can also seize upon the opportunity to tailor his services to his client's needs of the moment. Issues addressed in this commentary are: the practitioner's role in the commercial real estate transaction, the impact of the subprime loan crisis on the commercial mortgage market, current commercial

mortgage market lending practices and forecasts for 2008, the status of commercial foreclosures compared to residential foreclosures, and the challenges, solutions, and opportunities presented in commercial real estate projects.

The Practitioner's Role in the Commercial Real Estate Transaction and the Impact of Current Commercial Mortgage Market Conditions

In commercial real estate, the borrower or investor will either need or want to obtain financing for a large portion of the purchase price of a property, and the borrower or investor will seek to utilize leverage with the goal of maximizing the return on a given property and allowing for investment in multiple properties, in contrast to buying a single property for cash. The real estate investor's financing can come from several sources, including banks or institutional investors, such as pension funds and life insurance companies, which seek the rate of return offered by commercial real estate financing, secured by the investor's mortgage of the commercial property.

Given the cyclical nature of the real estate markets, changing economic conditions can affect the practitioner's role in representing a party throughout the course of transactions for the purchase or development of commercial real estate, including the source of financing, and specific terms sought by both the borrower and the lender, reflecting each party's interests in light of the prevailing economic conditions.

The Emergence and Effect of the Subprime Mortgage Industry Crisis

Subprime lending is the practice of providing high-risk borrowers with high-interest loans, and the subprime lending market developed in the United States in recent years as increasing numbers of consumers found themselves unable to access traditional mortgage financing. By 2005, the volume of subprime mortgage originations had increased 300 percent, and nearly 25 percent of all mortgage originations were considered as subprime, which included mortgage products such as interest-only and adjustable rate mortgages. Subprime mortgages were then sold to investment banks and packaged as mortgage-backed securities.

By late 2006, the foreclosure rate on subprime mortgages was on a steep rise, with disadvantaged subprime borrowers unable to meet the rate changes and increased payments on their subprime mortgage obligations. In the months to follow, numerous major subprime lenders filed for bankruptcy, and hedge funds with heavy investments in subprime mortgage-backed securities collapsed. Borrowers, lenders, investment banks, investors, shareholders, underwriters, and other parties have engaged in litigation, with claims ranging from predatory lending to misrepresentation in accounting and inadequate underwriting. 12-22 Mealey's Emerg. Ins. Disps. 17 (2007). In the commercial mortgage sector, by the third quarter of 2007, mortgage originations had dropped 4 percent when compared to the third quarter of 2006, and the commercial mortgage-backed securities market had fallen 28 percent when compared to 2006 levels. The subprime lending debacle has impacted the commercial lending practices of many of the nation's banks and has caused tightening in lending standards and criteria, further supported by concerns over falling commercial property values. Parke M. Chapman, *Office Rally Running Out of Gas*, National Real Estate Investor, Dec. 1, 2007, at 29.

Current Commercial Lending Practices, Trends, and Limitations

While the commercial real estate sector continues to fare better than the residential real estate sector, industry surveys reveal that economic concerns are expected to lead to more stringent underwriting standards for mortgages for commercial properties and multifamily housing units in 2008. However, analysts and experts also stress that opportunities are to be had in the commercial real estate market. Amy Cortese, *A Cloudy Forecast for Commercial Real Estate*, New York Times, Sun., Dec. 2, 2007 at 27. The practitioner should have the relevant economic conditions and challenges in mind while navigating the path of the client's commercial transaction.

In late 2006, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, and the Federal Deposit Insurance Corporation (the Agencies) issued a joint final guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (the Guidance). The purpose of the Guidance, which applied to

national banks, state chartered banks, and possibly bank holding companies, was to reinforce sound risk management practices for institutions with substantial concentrations of commercial real estate loans on their balance sheets in order to avert possible bank failures in the event of a real estate market decline. The Guidance set out thresholds for commercial real estate and construction and land development loans, which when reached by banks, directed precautions including the increase of the bank's capital; thresholds were set at 300 percent of a bank's capital for commercial real estate loans, and 100 percent for construction and land development loans. In response to opposition on such restrictions from small and midsize banks, the Agencies emphasized that the Guidance provided supervisory criteria and not lending limits on commercial real estate lending. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 *Fed. Reg.* 238 (Dec. 12, 2006). *Regulators Propose Property Loan Limits*, New York Times, Dec. 12, 2006 at C9.

Faced with tightening lending standards, the decline in the issuance of commercial mortgage-backed securities, and unfavorable economic conditions, the practitioner may see clients facing greater challenges in securing financing for their commercial real estate transactions. The practitioner may be called upon to contribute to the innovation and creativity required to obtain financing and to close a transaction. While commercial loan transactions are expected to fall in 2008 from an estimated \$250 billion in 2007 to \$200 billion in 2008, some mortgage brokers and direct lenders are achieving growth, and identification and utilization of such resources could be essential in securing complex and creative financing solutions. H. Lee Murphy, *Growth Amid A Downturn*, National Real Estate Investor, Dec. 1, 2007, p. 53. The reader is directed to the LexisNexis AnswerGuide New York Real Property for a general discussion of the range of sources available in commercial mortgage financing. 1-11 LexisNexis AnswerGuide New York Real Property § 11.05.

Other constant factors affecting commercial real estate clients and practitioners are regional differences and economies. In a December 2007 commercial real estate industry survey, respondents indicated the expectation that global and coastal cities including New York City, Washington, D.C., San Francisco, Los Angeles, and Seattle will appeal to real estate investors during uncertain economic times. Manhattan office rents continue to rise, and Manhattan vacancy rates, at 5 percent, are half of the nationwide average. Seattle benefits from its proximity to shipping routes, and it enjoys a broad range of employers. In contrast, smaller Midwestern cities and more remote areas are experiencing losses in key industries such as manufacturing, or do not have the appeal of the large "global" cities. Amy Cortese, *A Cloudy Forecast For Commercial Market*, New York Times, Sun., Dec. 2, 2007 at 27. For a concise illustration of the contrast of the differences between the commercial real estate market in New York City and upstate New York, see 1-1 New York Commercial Mortgage Transactions § 1.03.

Supply and demand fundamentals are always in motion. While low vacancy rates nationwide are seen in the commercial industrial sector, which includes properties such as warehouses and distribution centers, a downturn in consumer spending could negatively impact the industrial market. In suburban areas, where new construction is most often found, the focus of development could turn to shopping centers with downturn-resistant anchors such as supermarkets. Amy Cortese, *A Cloudy Forecast for Commercial Market*, New York Times, Dec. 2, 2007, at 27. Investor Sam Zell commented that with continued low unemployment rates, it was very unlikely that the subprime credit crisis would spread and that with a lack of new commercial construction, the current environment was good for the owners of commercial real estate. *Zell Says Subprime Meltdown is "Manageable,"* ChicagoBusiness.com, Dec. 12, 2007.

Commercial Foreclosures

While the daily news seems to deliver new reports of rising residential mortgage foreclosure rates, fueled by subprime lending, there does not appear to be a parallel increase in commercial mortgage foreclosures. With the tightening of credit, high-risk loans for new commercial projects are not available. The credit crunch having slowed new construction, it is possible that rents will be supported or will rise, and that a lack of new construction will support property values. Robert Evatt, *Commercial Property Feels Crunch*, Tulsa World, Sept. 28, 2007, at E2. While the commercial mortgage foreclosure rates do not mirror residential mortgage foreclosure rates, current economic

conditions serve to prompt attention to the terms addressing the interests and remedies of the parties to a mortgage transaction should default occur. In the early 1990's, foreclosure in New York, commercial or residential, required a judicial proceeding, and following the real estate market downturn of that era, NY CLS RPAPL § 1401 et seq. was amended in 1998 to provide for nonjudicial foreclosure proceedings. The reader is directed to 1-1 *Bergman on New York Mortgage Foreclosures* § 1.01 for a discussion of possible solutions to be incorporated at the time of the drafting of mortgage documents in anticipation of problems such as default.

Projects: Problems and Possibilities

There are clearly opportunities and rewards to be had in real estate investments, and the practitioner may be called upon for defensive planning, analysis, and action regarding a client's real estate projects. Real estate projects may start to encounter problems and fail during a general economic downturn, or added effort and ingenuity may be required to begin a project under such conditions. The parties to the project and the nature of their interests will have to be identified, as will ancillary parties involved in the project, such as contractors, tenants, or title insurers. Workouts require comprehensive terms and practicality. Solutions could include concessions such as extensions of terms, rate reductions, the transfer of control of a project to the lender via a deed in lieu of foreclosure, subordinated interest partnerships, or a consensual filing under Chapter 11. William G. Murray, Jr., *What to Do About the Problem Project?*, Practical Real Estate Lawyer, Sept., 2007. One mixed use project facing foreclosure in Southport, Connecticut consists of condominiums, town homes, and single-family homes, coupled with an inn, to have been offered as "condotel" units. The project's developers stopped making construction loan payments in the spring of 2007, about 6 months before securing an amended loan agreement and a line of credit in an effort to complete the commercial side of the project, to secure contracts and closings on the residential units, and to avoid foreclosure. One investor expressed that in hindsight, the commercial side of the project should have been completed first. Lisa Prevost, *Promises Foreclosed*, New York Times, Sun., Sept. 16, 2007, at sect. 11, p. 12. Exploration of possible problems and possible solutions at the outset of a project may influence the client's planning and execution of a project's plans, and leave the client in the best position possible to manage uncertainties and changes in the market.

In an environment of tightened financing, commercial real estate clients may seek a practitioner's guidance and assistance in pursuing alternative or supplemental financing from governmental sources at federal, state, and local levels. 1-11 LexisNexis AnswerGuide New York Real Property § 11.05. A client may be seeking out new opportunities, or changes in conditions may mean that a currently held property will now qualify for certain tax credits, favorable tax classifications, or governmental financing for development or redevelopment. The practitioner's knowledge of such opportunities, and the necessary strategies and procedures, particularly at a local or county government level, could be of key importance for the client in achieving a favorable return on an existing real estate investment or in securing financing and purchasing a desired property. For example, the owner of a vacant commercial property might seek a reclassification of the property for tax purposes, which in turn could facilitate the owner's efforts at redevelopment of the property, or make the property more attractive for resale to a potential developer.

Conclusion

The real estate practitioner is a valuable and indispensable member of the real estate investor's team, being in a position to advise his client as to the options and possibilities available in meeting the mortgage financing needs for a project. The practitioner will offer the best service to his client by assisting in securing the best mortgage product and terms for his client in light of the specifics of the commercial project and the dynamics at work in the economy.

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33 of 79 DOCUMENTS

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Auctions of Non-Distressed Real Estate

2008 Emerging Issues 76

Auctions of Non-Distressed Real Estate

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary addresses the real estate auction as one way for sellers in a depressed housing market to unload their homes. Traditionally used for distressed properties, the real estate auction is now a fast-growing phenomenon in the non-distressed market, too. This commentary lists the advantages and disadvantages of auctions of non-distressed properties for the buyer, the seller, and the realtor.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

The Associated Press reported on November 27, 2007 that Standard & Poor's nationwide housing index revealed a discouraging fact, United States home prices fell 4.5 percent in the third quarter from a year earlier. This was the sharpest drop since Standard & Poor's began its index in 1987 and another sign that the current housing slump is far from over. The index also showed that prices fell 1.7 percent from the previous three-month period, the largest quarter-to-quarter decline in the index's history.

As the much-lagging real-estate market makes homes harder to sell, determined sellers are trying a different approach: putting their house or condo on the auction block, rather than use traditional marketing methods. Auctioneers who are familiar with the home-selling by auction business report a significant surge of demand since housing markets began stalling over a year ago. They say auctions provide a quick exit for people who might otherwise wait months or years for a buyer to come along.

History of Using the Auction to Sell Real Property

The real estate auction has been the traditional method for selling distressed real estate involved in mortgage or lien foreclosures, judicial attachments, property tax foreclosures and bankruptcy proceedings. Practitioners in this area of debtor and creditor law know the pitfalls of the auction as a means of selling real property, and are more than abundantly aware of the fact that it is common knowledge that, at least in the sense of distressed sales, the auction price is significantly discounted from the true value of a given property. Moreover, auctions are not a common way of arranging arms-length market sales of real estate in the United States. For these reasons, brokers and other advisers to owners of real estate discouraged the use of auctions except in extreme circumstances.

Notwithstanding tradition, the recent drop in home values together with the burgeoning mortgage foreclosure rates have caused property owners, realtors, and investors to re-examine the perceived negative aspects of real estate auctions as a viable method to selling real estate, albeit to avoid the foreclosure. Consequently, companies that heretofore specialized in auctions, and in particular auctioning of real estate, demonstrated that a real estate auction was a desirable method of selling real estate, regardless of whether it was residential or commercial. Thanks to intense marketing efforts, hundreds of thousands of successful sales, and positive referrals, those first auction companies are now seen as pioneers in the field. Those companies include Sheldon Good & Company, LLC (Chicago, Illinois), Cantor Fitzgerald & Co. (New York, New York), and Kennedy Wilson, Inc. (Santa Monica, California). In 1998, Homebid.com held the first successful real estate auction over the Internet.

According to estimates by the National Association of Realtors (NAR), 30 percent of all real estate will be sold through auctions by the year 2010. *See*, Harold D. Hunt, *Going Once, Going Twice, Sold!*, Tierra Grande, July 2002. There has been a significant increase in the use of auctions between 1980, when \$10 billion was sold in the United States, and 1999, when \$49.5 billion was sold. *Id.* The fastest growing auction areas in 2004 were land and agricultural real estate (14.7 percent increase), residential real estate (14.1 percent increase), and commercial real estate (11.1 percent increase). The NAR has recognized the viability of the auction market for non-distressed real properties to such an extent that it now offers its members and also the general public a website for further information.

Advantages and Disadvantages of Using Auctions

Advantages

The NAR reports a number of significant benefits to the seller, buyer and the realtor when non-distressed real estate is sold by auction.

Benefits to the Seller:

Buyers come prepared to buy

Quick disposal reduces long-term carrying costs, including taxes and maintenance

Assurance that property will be sold at true market value

Exposes the property to a large number of pre-qualified prospects

Accelerates the sale

Creates competition among buyers -- auction price can exceed the price of a negotiated sale

Requires potential buyers to pre-qualify for financing

The seller knows exactly when the property will sell

Eliminates numerous and unscheduled showings

Takes the seller out of the negotiation process

Ensures an aggressive marketing program that increases interest and visibility

Benefits to the Buyer:

Smart investments are made as properties are usually purchased at fair market value through competitive bidding

The buyer knows the seller is committed to sell

In multi-property auctions the buyer sees many offerings in the same place at the same time

Buyers determine the purchase price

Auctions eliminate long negotiation periods

Auctions reduce time to purchase property

Purchasing and closing dates are known

Buyers know they are competing fairly and on the same terms as all other buyers

Buyers receive comprehensive information on property via due diligence packet

Benefits to the Realtor:

Generates a list of ready, qualified buyers

Offers clients and customers new selling and purchasing options

Increases revenue and market share

Develops your own market niche

Assurance that property will be sold at true market value

Property is sold within a relatively short period of time

Exposes the property to many potential purchasers

Auctions bring people in to look at all your listings, not just the auction listing

Successful auctions result in referrals and return business

Agents can earn commissions as referring agent/broker, cooperating agent/broker, or as the listing agent/broker

These benefits, and additional statistics tabulated by the NAR, can be found on one of its satellite websites.

Disadvantages

In their recent article on real estate auctions in the *Real Property, Probate & Trust Journal*, Steven Good and Celeste Hammond described advantages and disadvantages to the use of auctions to sell non-distressed residential or commercial real estate (Steven L. Good and Celeste M. Hammond, *Real Estate Auctions--Legal Concerns for an Increasingly Preferred Method of Selling Real Property*, 40 *Real Prop. Prob. & Tr. J.* 765 (Winter 2006)). Their analysis reflects state case law, including contract and tort causes of action that can be asserted against sellers, buyers, real estate brokers and agents and also against auctioneers in a civil prosecution for damages, specific performance and/or injunctive relief. Included in their discussion are the following "auction practices that undercut the reputation of the industry":

- . "Sales Talk" and fraud in the inducement
- . Misinformation about seller's right to cancel an absolute auction
- . Auctioneer's failure to require bidder to comply with registration requirements

- . Shill bidders, fraudulent bidders and by-bidders
- . Seller bidding
- . Unclean hands
- . Deceptive advertising

Legal Rules That Affect the Auction Process

Real Estate Broker Licensing Statutes

In most states, regulating brokers and salespersons is accomplished through comprehensive licensing schemes; all of the states impose some sort of licensing requirement on real estate brokers and salespersons, as revealed by the following list:

Alabama: Code of Ala. § 34-27-1 et seq.; *Alaska:* Alaska Stat. § 08.88.161; *Arizona:* A.R.S. § 32-2101 et seq.; *Arkansas:* Ark. Stat. Ann. § 17-42-101 et seq.; *California:* Cal. Bus. and Prof. Code § 10130 et seq.; *Colorado:* Colo. Rev. Stat. § 12-61-101 et seq.; *Connecticut:* Conn. Gen. Stat. § 20-311 et seq.; *Delaware:* Del. Code Ann, tit. 24 § 2901 et seq.; *District of Columbia:* D.C. Code § 42-1701 et seq.; *Florida:* Fla. Stat. § 475.01 et seq.; *Georgia:* Ga. Code Ann. § 43-40-7 ; *Hawaii:* Hawaii Rev. Stat. § 467-1 et seq.; *Idaho:* Idaho Code Ann. § 54-2001 et seq.; *Illinois:* 225 Ill. Comp. Stat. 454/1-1 et seq.; *Indiana:* Burns Ind. Code Ann. § 25-34.1-3-4.1; *Iowa:* Iowa Code Ann. § 543B.1 et seq.; *Kansas:* Kan. Stat. Ann. § 58-3034 et seq.; *Kentucky:* Ky. Rev. Stat. § 324.010 et seq.; *Louisiana:* La. Rev. Stat. Ann. § 37:1430 et seq.; *Maine:* 32 Me. Rev. Stat. Ann. § 13001 et seq.; *Maryland:* Md. Business Occupations and Professions Code Ann. § 17-101 et seq.; *Massachusetts:* Mass. Gen. Laws Ann., ch. 112 § 87PP et seq.; *Michigan:* Mich. Comp. Laws § 339.2501 et seq.; *Minnesota:* Minn. Stat. Ann. § 82.17 et seq.; *Mississippi:* Miss. Code Ann. § 73-35-1 et seq.; *Missouri:* Mo. Ann. Stat. § 339.020 et seq.; *Montana:* Mont. Code Anno., § 37-51-301 et seq.; *Nebraska:* Neb. Rev. Stat. § 81-885.02 ; *Nevada:* Nev. Rev. Stat. § 645.330 et seq.; *New Hampshire:* N.H. Rev. Stat. Ann. § 331-A:3 et seq.; *New Jersey:* N.J. Stat. Ann. § 45:15-1 et seq.; *New Mexico:* N.M. Stat. Ann. § 61-29-1 et seq.; *New York:* NY CLS Real P § 440 et seq.; *North Carolina:* N.C. Gen. Stat. § 93A-1 et seq. and N.C. Gen. Stat. § 105-41; *North Dakota:* N.D. Cent. Code § 43-23-05; *Ohio:* Ohio Rev. Code Ann. § 4735.01 et seq.; *Oklahoma:* 59 Okl. St. § 858-301 et seq.; *Oregon:* ORS § 696.020 et seq.; *Pennsylvania:* Pa. Stat. Ann, tit. 63, § 455.101 et seq.; *Rhode Island:* R.I. Gen. Laws § 5-20.5-1 et seq.; *South Carolina:* S.C. Code Ann. § 40-57-20; *South Dakota:* S.D. Codified Laws § 36-21A-1 et seq.; *Tennessee:* Tenn. Code Ann. § 62-13-301 et seq.; *Texas:* Tex. Occ. Code § 1101.351 et seq.; *Utah:* Utah Code Ann. § 61-2-1 ; *Vermont:* Vt. Stat. Ann., tit. 26, § 2211 et seq.; *Virginia:* Va. Code § 54.1-2100 et seq.; *Washington:* Wash. Rev. Code Ann. § 18.85.010 et seq.; *West Virginia:* W. Va. Code § 30-40-1 et seq.; *Wisconsin:* Wis. Stat. Ann. § 452.01 et seq.; *Wyoming:* Wyo. Stat. § 33-28-101 et seq.

For a discussion of the specific licensing requirements in all 50 states, see 10A-6 Real Estate Brokerage Law and Practice 6.syn.

The various state licensing statutes all have the same general purpose: to protect the public from fraud and misrepresentations of dishonest or incompetent persons. The transactions subject to licensing vary from state to state.

Auction and Auctioneer Licensing Statutes That Include Auctions of Real Estate

As a general rule, once a state regulates persons or licensees, it extends its coverage to a broad scope of regulated activities and businesses. The National Association of Real Estate License Law Officials (NARELLO) Model License Law is typical of the types of activities regulated pursuant to a real estate broker's license. Section 3(4) of that model law broadly defines a "Broker" as an individual or professional association, while acting for another for commissions or other compensation or the promise thereof, or a licensee under this chapter, while acting in his own behalf who, inter alia, "auctions, offers, attempts or agrees to auction real estate." Consequently, many states, because of their unique real

estate laws, have enacted real estate licensure requirements for other activities such as auctioneers of real estate. They are required in all states either as a broker's license or as a broker and accompanied with a separately maintained license, except for California, Delaware, District of Columbia, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Pennsylvania, Texas, Vermont, Virginia. Licensure requirements vary from state to state, from simply registering and paying fees to more exacting educational requirements and professional standards.

Auctioneers generally serve as agents of the sellers; as such, they draft and execute the memorandum of the sale and the purchase agreement on behalf of the sellers. The duties imposed on an auctioneer include diligence, obedience, disclosure, accounting, and loyalty as a fiduciary to the seller. *See, Jorge Contreras, The Art Auctioneer: Duties and Assumptions, 13 Hastings Comm. & Ent. L.J. 717, 723 (1991).* The duty of diligence requires the auctioneer to do all it can to obtain the highest price for the property by extensive advertising that builds excitement into the bidding process. The duty of disclosure requires the auctioneer to inform the seller of all material facts that might affect the seller.

The Auction Contract

The auction contract is not similar to the exclusive listing contract that the seller signs in favor of the real estate broker. The auction (listing) agreement is more complicated than the exclusive listing agreement used in conventional sales of real estate because it contemplates a defined and structured timeline that is not easily changed once set. On the other hand, the exclusive listing agreement is much more flexible as to timing, listing price, and various sundry terms.

The contract does, however, create an agency relationship that places the auctioneer in a fiduciary relationship with the seller. *See generally 7 Am. Jur. 2d Auctions and Auctioneers §§ 65-69 (2005).* Section 13 of the Restatement (Second) of Agency states that "an agent is a fiduciary with respect to matters within the scope of his agency." Under this principle, the auctioneer has a duty to act in the best interests of the seller. The disadvantages of the auction, as set forth in Paragraph II.B, above, involve common scenarios where the auctioneer was involved in a breach of fiduciary duty to the seller. *Cf. Rose v. National Auction Group, 2000 Mich. App. LEXIS 2407 (Mich. Ct. App. 2000)* (puffing or sales talk; shill bidders, fraudulent bidders and by-bidders; unclean hands); *Bowling Transp. v. Gregg, 103 Ohio App. 3d 539 (Ohio Ct. App. 1995)* *Red Cardinal Fifteen v. Lange, 1997 U.S. App. LEXIS 1411 (4th Cir. 1997)* (misinformation about seller's right to cancel an absolute auction); *Mabry v. Like, 2003 OK CIV APP 73 (Okla. Ct. App. 2003)* (seller bidding); *Zajac Farms, Inc. v. Grueneich, 2006 Minn. App. Unpub. LEXIS 77 (Minn. Ct. App. Unpub. 2006)* (deceptive or false advertising).

High Bid Rejection

In a reserve bid auction, the highest bidder may not be the person that acquires the subject property. In a reserve auction, the seller usually has the right to cancel the highest bid for no reason at all. Typically, the bidder's offer and the seller's acceptance give rise to a contract between the parties. Thus, there would be no contract because the seller's cancellation negates an acceptance of the bidder's offer. But, in the case of a bidder who is denied his higher bid at an absolute auction, where the auctioneer set a specific bid increment, a court may use a different contracts analysis. *See Pitchfork Ranch Co. v. Bar TL, 615 P.2d 541, 542 (Wyo. 1980).* The lesson to be learned is that it is imperative for a buyer at auction to know exactly what type of auction she is attending and her rights in the bidding process. *See Mabry v. Like, 2003 OK CIV APP 73 (Okla. Ct. App. 2003).*

Comparison of Auction Sales and Traditional Sales

Absolute Auction, Reserve Auction or Minimum Bid Auction

In the traditional sale of real estate, the price is somewhat based upon the listing price of the property, which is set by the owner and the broker. Typically, the price "negotiated" by the buyer and the seller is very close to the listing

price, unless the property is flawed. In an auction sale, a buyer may purchase a property through an "absolute auction," a "reserve auction" or through a "minimum bid auction." The buyer's best chance of obtaining a deal is through the absolute auction because with an absolute auction, the seller has committed to selling the property to the highest bidder without any minimum set price. In a reserve auction, a property is listed for a specific minimum price, undisclosed at the auction. In a minimum bid auction, bids are accepted at or above an advertised minimum price. Reserve auctions, however, are most often used because sellers frequently need a specific amount to pay off a mortgage.

Price Determination by Bid

In the traditional sale, buyers rarely know what other buyers offer for a given property. During the auction, buyers have the comfort of seeing the home's market value established. "A home auction typically takes less than 10 minutes. During the bidding process, buyers see what others are willing to pay for a home, so they don't end up bidding more than is necessary to secure the sale," said Val Gehringer, Realtor and national auction coordinator for Keller Williams Realty, Winchester, Va., in *Going, Going, Gone! Realtors Help Buyers and Sellers Connect at Auction*, PR Newswire, Nov. 14, 2007.

Contingencies

As Steven Good and Celeste Hammond have explained, prospective buyers must understand that private auctions greatly differ from public, forced-sale auctions used in foreclosures, because buyers can perform more due diligence before the bidding begins. *40 Real Prop. Prob. & Tr. J.* 765. However, a significant difference is that there are no contingencies associated with the auction sale. The traditional sale contract may contain contingencies for, inter alia, financing, title inspection, home inspection, and the sale of the buyer's existing home. In an auction sale, the buyer is required to resolve or satisfy herself that all of the contingencies are satisfied. This is because the striking of the hammer signifies that the sale is completed. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Non Judicial Foreclosure Act*, 53 *Duke L.J.* 1399, 1414.

Seller Expenses

In the traditional sale, the seller pays a commission to his listing broker at the time of closing. In an auction sale, while the auctioneer prepares, coordinates, and places all advertising, the advertising expense is generally the responsibility of the seller and is usually paid to the auction company at the signing of the auction contract. In general, auction expenses include the auction company's commission, marketing and advertising, and co-brokerage commissions (sometimes). Typically the auction company charges a commission as a percentage of the sale price. This commission is negotiable. A complete marketing proposal should be provided for the seller's approval prior to signing. The auctioneer (or in some cases, the seller) usually pays a co-brokerage commission, either a flat fee or percentage of the sale price, if the high bidder and ultimate closer on the property is represented by the broker who registered the bidder prior to the sale. National Association of Realtors Marketing Guidelines.

Seller Disclosures

In some states, a home seller, with certain exceptions, is required to furnish the buyer with a seller's disclosure statement prior to entering into a binding agreement for the purchase and sale of a home. For instance, the Michigan Seller Disclosure Act, MCLS § 565.951 et seq., requires a seller to complete and deliver a disclosure statement to a prospective buyer before the buyer executes a binding purchase agreement. The Act applies to the transfer of any interest in real estate consisting of not less than one or more than four residential dwelling units. The disclosure statement must be in the form set forth by statute, MCLS § 565.957, and must be made available to the public by all real estate brokers and salespersons. In addition, in all parts of the country, a seller is required to furnish the prospective buyer with a federally mandated "Lead Disclosure Statement" where applicable (discussed in Real Estate Brokerage Law and Practice, ch. 15A, Lead-Based Paint Disclosure (LexisNexis Matthew Bender)). Required disclosures must be provided to prospective bidders prior to the beginning of the auction.

Conclusion

The sale of non-distressed real estate by auction is a relatively new procedure which allows sellers to have their property exposed to multiple interested buyers who simultaneously bid the price. Its widespread use in the modern real estate market in the United States is new, and the real estate auction may be facing reforms in response to concerns such as those expressed in Steven L. Good and Celeste M. Hammond, *Real Estate Auctions--Legal Concerns for an Increasingly Preferred Method of Selling Real Property*, 40 *Real Prop. Prob. & Tr. J.* 765 (Winter 2006).

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34 of 79 DOCUMENTS

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Update On Subprime Lending

2008 Emerging Issues 81

Update On Subprime Lending

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary examines high-cost loans, disclosures, truth-in-lending, foreclosures, and bankruptcy. Also discussed is the subprime rescue package presented by President Bush on Dec. 7, 2007.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

Generally, subprime lending is the practice of lending money to borrowers who otherwise would not qualify for a loan. Subprime lending thus makes credit available to those who might not otherwise have access to loans, and to that extent, it serves a positive function. However, various factors, including predatory lending, have caused subprime lending to impact the housing market and the economy in negative ways, resulting in what has been termed the subprime crisis. This article will concentrate on subprime lending in the residential mortgage market and will address various issues such as high-cost loans, disclosures, truth in lending, foreclosures and bankruptcy. (The term "subprime" as it is used in this article refers to the borrower's status and not the interest rate of the loan.) Lenders first seek out the best qualified borrowers, but in the modern economy with so many people owning valuable residential real estate, some lenders have developed a specialty of lending to borrowers who would not qualify for ordinary loans. As many of the subprime loans come to the end of their low introductory interest rate periods, defaults have become more common, and foreclosures rates have outpaced those of the broader mortgage market.

The federal Truth In Lending Act (TILA), 15 USCS § 1601 through 15 USCS § 1649, was enacted because of a perceived need for greater understanding of credit and the informed use of credit. 15 USCS § 1601(a). TILA was intended to create stabilization of credit markets by requiring disclosures prior to the execution of loan transactions to allow consumers to compare their credit options on an even basis through meaningful disclosure of credit terms, with an emphasis on the true cost of credit. TILA was the beginning of an era of federal preemption of historically state regulated controls on lending and borrowing. Similar to interstate highways, financial markets thrive on uniformity. According to Julie L. Williams and Michael S. Bylsma, federal preemption through legislation such as TILA was seen as a way to support a national commerce in financial services. Julie L. Williams and Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 Bus. Law. 1193 (May 2004).

To enforce TILA, the Board of Governors of the Federal Reserve System enacted Regulation Z, 12 CFR 226.1,

which applies to individuals or businesses that offer or extend credit when four conditions are met: (i) The credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly; (iii) the credit is subject to a finance charge or is payable by a written agreement in more than 4 installments; and (iv) the credit is primarily for personal, family, or household purposes. For home equity plans, 12 *CFR* 226.5b sets forth the required disclosures. Under 12 *CFR* 226.5b, a home equity lender is required to conspicuously disclose on the loan application or on a separate form all third-party fees, and in the case of a variable-rate loan, 12 *CFR* 226.5b(d)(12) requires the conspicuous disclosure of the terms under which the interest rate varies.

While TILA is the main controlling legislative enactment relative to credit, there are other federal statutes that each have a sub-function within the broader regulatory scheme. In some sense, it could be said that the present subprime lending crisis is partially a result of the Community Reinvestment Act, (ACT) 12 *USCS* § 2901. The Act was intended to encourage lending institutions to help meet the credit needs of the communities in which they operated, including low- and moderate-income neighborhoods. The Act required insured depository institutions to help meet the credit needs of the entire community and provided for periodic evaluations. An institution's performance in serving the community was taken into account when considering an institution's application for deposit facilities, including mergers and acquisitions. This utility model of regulation of lending may have actually contributed to the growth of the subprime lending industry. Subprime loans at the time of the Act carried about twice the cost to the borrower as opposed to prime loans.

The Home Ownership Equity Preservation Act, 15 *USCS* § 1639, was enacted by Congress in 1994 as an attempt to fight predatory lending. In light of the ineffectiveness of this federal legislation, some states have enacted laws aimed at curbing abusive and predatory lending practices. Tania Davenport writes that abuses amounting to predatory lending commonly fall into a few distinct categories: providing misinformation; using aggressive sales tactics against vulnerable consumers; taking unfair advantage of the consumer's lack of understanding or information; and fraud. Tania Davenport, *NOTE: An American Nightmare: Predatory Lending in the Subprime Home Mortgage Industry*, 36 *Suffolk U. L. Rev.* 531, 534 (2003).

Impact on the Economy

A typical borrower in the subprime mortgage market is "house-rich" but "cash-poor," having built up equity in his home but in little else, and has a lower net income than the average borrower. *Henry v. Lehman Commer. Paper, Inc.*, 471 F.3d 977 (9th Cir. 2006). According to John Gibeaut, "unsophisticated consumers sitting on all this equity provide a tremendous incentive for thieves." 93 *A.B.A.J.* 50 (July 2007). A typical loan product in the subprime market is a hybrid adjustable rate mortgage (ARM).

Hybrid ARM products represented more than 60% of all subprime mortgages originated in 2006. Recent statistics reported in a nationwide survey by the Mortgage Bankers Association (MBA) showed that 14.44% of subprime borrowers with ARM loans were at least 60 days delinquent in their payments in the fourth quarter of 2006. This delinquency rate was an increase from the third quarter 2006 rate of 13.22%. According to the MBA survey, foreclosure start rates for subprime loans increased from 1.82% to 2% during the fourth quarter of 2006. 2007 OCC Enf. Dec. LEXIS 31 (OCC Enf. Dec. 2007).

In spite of the upturn in loan defaults and foreclosure rates, the impact of subprime lending on the economy is difficult to measure. The Home Mortgage Disclosure Act of 1975 (HMDA), 12 *USCS* § 2801 et seq., does not require lenders to identify loans as subprime. Industry estimates of the size of the subprime market generally concur as to its growth, with the subprime lending market estimated by Baher Axmy to be \$173 billion in 2001 and over \$200 billion in 2002, with growth of nearly 50 percent to 330 billion in 2003. Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 *Fla. L. Rev.* 295, 307 (2005).

In addition, national banks, which are tightly controlled, provide a relatively low percentage of all subprime loans, thereby making the impact of subprime lending more difficult to estimate. Subprime lending by national banks amounts

to less than 10 percent of all subprime lending, and national banks report a delinquency rate of about half the industry average. Other lenders that are more loosely controlled make up the vast majority of subprime lenders. Further, because those loans are not originated in the national banking system, they are not overseen by the Office of the Comptroller of Currency. State-regulated nonbank lenders and brokers that originate subprime loans have captured the largest share of the subprime market recently -- primarily because hedge funds and private equity investors provided extraordinary liquidity to fuel this growth by purchasing loans originated by nonbanks, as well as securities backed by these loans, in the secondary market. 2007 OCC Enf. Dec. LEXIS 31 (OCC Enf. Dec. 2007).

Mortgage Fraud

While not all subprime loans are predatory, those targeted at borrowers who are not able to pay their loans are the subject of increasing scrutiny. Predatory lending is described by Kathleen C. Engel and Patricia A. McCoy as a syndrome of loan abuses that benefit mortgage brokers, lenders, and securitizers to the serious detriment of borrowers. Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *Fordham L. Rev.* 2039 (March 2007). Predatory practices as applied to National Banks under 12 CFR 34.3 prohibit the lending of money based on the foreclosure or liquidation value of the borrower's collateral and without regard for the borrower's ability to pay the loan under its terms. The provisions of the Federal Trade Commission Act, 15 USCS § 45 et seq., bar a national bank from engaging in an unfair or deceptive trade practice.

In addition to applying consumer protection to lending, at least one federal court has considered the issue of minority lending within the context of fraud in lending. Where a plaintiff presents evidence of "intentional targeting" with respect to predatory lending, he or she need not also show more favorable treatment to other non-protected persons. To hold otherwise would allow predatory lending schemes to continue as long as they are exclusively perpetrated upon one racial group. *Barkley v. Olympia Mortg. Co.*, 2007 U.S. Dist. LEXIS 61940 (D.N.Y. 2007).

Another common but potentially illegal activity is house "flipping." In the context of mortgage fraud, flipping involves a developer purchasing a house, performing only minimal repairs, and selling the house at a large profit. In *Barkley*, several first-time home buyers filed suit against real estate companies, lenders, appraisers, and lawyers, claiming that the defendants had conspired to sell the plaintiffs over-valued, defective homes financed with predatory loans and had targeted them because they were minorities.

The plaintiffs alleged that the defendants had discriminated against them in violation of federal anti-discrimination statutes, including the Fair Housing Act, 42 USCS § 3604, and 42 USCS § 1981, 42 USCS § 1982, and 42 USCS § 1985. The plaintiffs also asserted state-law claims of fraud, conspiracy to commit fraud, legal malpractice, negligence, violations of New York's consumer protection statute, NY CLS Gen Bus § 349, and state and local anti-discrimination statutes, including the New York State Human Rights Law, Executive Law, NY CLS Exec § 296. The crux of the plaintiffs' claims was that the defendants had conspired to sell homes that had been purchased at foreclosure sales, with the resale prices nearly double the purchase prices, after only performing cosmetic repairs, with allegations of "reverse red-lining" against the defendants. The plaintiffs' claims survived a motion to dismiss and the case remains pending.

The issue has been addressed in state courts as well. Under Massachusetts law, lenders are judged by an unconscionability standard in the charging of points or fees, while under TILA and the federal regulations disclosure is required. The unconscionability standard used in Massachusetts essentially allows state-based consumer protections to apply to loans subject to TILA. In *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192 (D. Mass. 1998), a Massachusetts federal court held that the so-called Points Statute, ALM GL ch. 183, § 63, was valid and did not allow lenders to charge any amount of points or fees, because an "unconscionability" standard applied a fraud determination as to such costs associated with borrowing.

Regulation of Mortgage Brokers

24 CFR 3500.2 defines a mortgage broker as a person (not an employee or exclusive agent of a lender) who brings

a borrower and lender together to obtain a federally related mortgage loan, and performs settlement services, often described as closing or escrow services. For example, North Carolina defines a mortgage broker as a lender in N.C. Gen. Stat. § 24-2.5. In addition, North Carolina has enacted thresholds generally considered more stringent than those in TILA for high-cost home loans. N.C. Gen. Stat. § 24-1.1E.

Securitization

Engel and McCoy also write that "securitization is the integration of the market for residential mortgages with the capital markets." *75 Fordham L. Rev.* 2039, 2044 (2007). Because lenders can pick and chose which loans they want to keep and which they want to sell, the incentive to reduce risk by using traditional underwriting standards is reduced. The loan securitization process involves a broker or an originator, with possibly a bulk line of credit, or an agency relationship with a capital funding source. After recordation of the loan, the debt is transferred to a securitization sponsor who bundles the loans to a special purpose vehicle and the loans or shares in an entity made up of the loans are sold as securities.

In *FDIC v. Bakkebo*, 2007 U.S. App. LEXIS 24948 (4th Cir. 2007), a United States District Court awarded \$161 million in damages against an individual civil defendant who operated a loan services company and securitized subprime loans sold to a federally insured bank. The court held that misrepresentations by the individual to a federally insured bank that had a negative effect on the bank's cash flow was a proper measure of damages.

Underwriting Criteria

The Final Guidance on Subprime Mortgage Lending states that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. *72 FR* 37569. As Engel and McCoy state "The reality is that given the large volume of loans and supporting documentation and the large number of lenders, underwriters can only rely on automated compliance coupled with labor-intensive and high-cost manual inspection, with only a representative sample of loan applications reviewed." *75 Fordham L. Rev.* 2039, 2083 (2007). Many commentators agree that underwriting criteria are a good idea. Engel and McCoy state further, "[S]ecuritization's lack of concern about subprime underwriting seems odd. After all, investors in mortgage-backed securities should be concerned about the heightened default risk of subprime loans and predatory loans in particular." *75 Fordham L. Rev.* 2039, 2040 (2007).

The Final Guidance on Subprime Mortgage Lending, *72 FR* 37569, addresses the spread between the initial fixed interest rate and the fully indexed interest rate on a 2/28 30-year mortgage, often called an ARM. Commentators have suggested that the full-index rate should be used in underwriting such loans. Subprime loans include those loan products with high or no limits on interest rate increases, limited documentation of income, borrower requirements for frequent refinancing, and prepayment penalties beyond the initial rate period. Such loans pose greater risks to borrowers. However, not all subprime loans are predatory and loans in compliance with the Statement are not necessarily predatory in nature. The Guidance suggests that with appropriate underwriting standards, including capacity to repay -- both principal and interest obligations -- expenses, and the use of overall debt-to-income ratios, and the setting aside of adequate reserves, subprime lenders will not run afoul of the law.

Bankruptcy

What happens when a borrower files for bankruptcy protection? In *Till v. SCS Credit Corp.*, 541 U.S. 465 (U.S. 2004), the court considered the debtor's overall position and applied a rate that was lower than the contract rate to a Chapter 13 adjustment plan. The court essentially found against a creditor in holding that a plan allowing the creditor a claim on the amount of the claim plus 9.5% interest, a rate in excess of the risk-free rate of return was sufficient. In that case, a Chapter 13 debt adjustment under a plan that called for an interest rate tied to the national prime rate, adjusted to reflect the risks associated with the debtors, was approved over the objection of the lender. The lender had sought to have the contract rate applied. The court reasoned that a "cram down" provision in accordance with *11 USCS* § 1325

was authorized, allowing a bankruptcy court to apply a formula to the debtors overall position in order to arrive at an interest rate for a subprime truck loan covered by the debtors' debt adjustment plan. Under 11 USCS § 1325, the plan needed only to propose an interest rate that would compensate a creditor for the fact that if the creditor had received the property immediately rather than at a future date, the creditor could have immediately made use of the property.

In *Henry v. Lehman Commer. Paper, Inc.*, 471 F.3d 977 (9th Cir. 2006), the court found an underwriter liable after the bankruptcy of a lender. A mortgage company was driven into bankruptcy by allegations of fraudulent lending practices. A class of borrowers sought to impose aiding and abetting liability on the underwriter of the securitized debt of the mortgage company. The underwriter countered that it had merely provided a warehouse line of credit. Liability was found but punitive damages were denied.

On either side of the equation, the message seems to be that courts will not tolerate the use of the statutes and complex business agreements as shields against liability, thereby giving teeth to the provisions of 15 USCS § 1641. Under TILA at 15 USCS § 1641(c), if an originator fails to make the required disclosures to borrowers, the borrower may exercise the right of rescission -- expanded to three years under 15 USCS § 1635(f) -- against the assignee even if the TILA violation is not apparent on the face of the loan documents. In light of a statutory scheme designed to allow recovery against underwriters, one would think that detailed underwriting criteria would be in place but this is not the case.

Legislative Responses

The mortgage lending industry is generally subject to the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act of 1974, the Home Ownership and Equity Protection Act of 1994, the Home Mortgage Disclosure Act of 1975, and the Fair Housing Act.

2007 H.R. 2061 is a bill intended to protect home buyers from predatory lending practices. The proposed Predatory Mortgage Lending Practices Reduction Act operates essentially as an amendment to the Real Estate Settlement Procedures Act of 1974, 12 USCS § 2601 et seq. The new section proposes that no person may provide mortgage lending or brokerage services unless certified as having been adequately trained with regard to subprime lending. The bill also requires the Secretary to define "predatory lending" and requires the Secretary to define "subprime" as a loan with a higher risk of default than those loans made to borrowers at prime rates.

In addition, the bill puts forth an amendment to the TILA in the form of a "best practices" plan, which requires lenders to review the performance of their agents and to make good faith efforts to resolve consumer complaints relative to lending practices. The bill also contains a provision to be added to the TILA directed at the use of appraisals, barring compensation, coercion, or intimidation of any individual conducting or involved in an appraisal. This provision is in response to the practice of "flipping," under which a developer -- often in conjunction with other individuals in the lending process -- purchases a home, completes basic repairs, and resells the home at a highly inflated price, the practice at issue in *Barkley v. Olympia Mortg. Co.*, 2007 U.S. Dist. LEXIS 61940 (D.N.Y. 2007).

In the Senate, 2007 Bill Tracking S. 1299 has been introduced and is intended to establish that a fiduciary relationship exists between a home mortgage lender and borrower. The provision is part of the Borrower's Protection Act of 2007, also designated as an amendment to TILA. In addition, the proposed bill requires lenders to verify the borrower's reasonable ability to pay the principal and interest, real estate taxes, and homeowners' insurance fees and premiums.

Because of the equity erosion present in the subprime lending industry, a change to 11 USCS § 548 has been proposed. Under 11 USCS § 522(f), a debtor may exclude his home equity from the reach of creditors. The ability of subprime lenders to tap into that equity to the exclusion of other creditors is the subject of the proposed change, based on a belief that the credit transaction did not adequately benefit the debtor.

The Bankruptcy Code achieves essentially a social insurance objective in part by permitting a debtor to remove

from the reach of unsecured creditors certain core assets, one of which is the equity in his or her home. In addition, the Bankruptcy Code seeks to achieve a policy objective of treating unsecured creditors fairly in the overall proceedings. In *38 Loy. U. Chi. L.J. 81, 84 (Fall 2006)*, R. Stephen Painter Jr., an attorney with the U.S. Commodity Futures Trading Commission, proposed two changes. First, as to *11 USCS § 522(f)(1)(B)*, a debtor should be permitted to avoid that portion of an overreaching subprime mortgage lender's lien that impairs his ability to enjoy an exemption in home equity that the debtor would otherwise have enjoyed had the subprime lender not charged too much for credit. Second, the trustee should be permitted to use *11 USCS § 548(a)(1)(B)* to avoid that portion of a subprime mortgage lien which, as a result of subprime lender overreaching, reduces distributions to unsecured creditors.

Subprime Rescue Package

In the face of increased mortgage default rates and an accompanying ripple effect on the rest of the economy, Henry Paulson, U.S. Treasury Secretary has orchestrated a subprime rescue package to use available regulatory tools and create new ones in an effort to help struggling but responsible homeowners. The rescue package would apply only to owner-occupied homes, not homes bought as investment, and would be limited to borrowers who can afford their payments now, but who won't be able to afford the increased payments after expiration of the introductory rate period. The rescue package will not include borrowers who can afford the higher payment, borrowers behind in the payments, and borrowers who can refinance into a fixed rate mortgage. The hope is that while the plan will not solve every borrower's problem, it will prevent far reaching problems for the economy as a whole. The package was presented by President Bush Thursday, December 6, 2007, as a voluntary private-sector plan to freeze interest rates for many borrowers at risk of losing their homes. Under the announced plan, designated borrowers who face an upward reset in their interest rate will be allowed to keep their current mortgage payments for a five-year grace period. Trumball, Mark, *Bush Takes Steps to Solve Loan Crisis*, Christian Science Monitor, Dec. 7, 2007.

Conclusion

Subprime lenders generally charge somewhat higher interest rates to account for the increased risk associated with subprime loans. Subprime lending allows individuals such as the self-employed and owners of commercial and investment properties to have access to credit that otherwise would not be available to them.

As Wayne Rushton, Chief National Bank Examiner at the Office of the Comptroller of the Currency, told the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, it's easy to forget in this environment that subprime loans have enabled millions of Americans -- including many low and moderate income people -- to become homeowners for the first time. Most of these folks are paying their loans on time and are expected to continue doing so. This reminds us that not all subprime loans are inherently predatory or abusive. But those that are have no place in the banking system. 2007 OCC Enf. Dec. LEXIS 31 (OCC Enf. Dec. 2007).

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35 of 79 DOCUMENTS

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Professor Kent Sinclair on Kitchen v. City of Newport News, 275 Va. 378 (2008).

2008 Emerging Issues 2709

Inverse Condemnation in Virginia: the Intersection of the Fifth Amendment, Virginia Statutes, and Basic Pleading Requirements.

By Kent Sinclair

August 15, 2008

SUMMARY: In its thorough decision in *Kitchen v. City of Newport News, 275 Va. 378 (2008)*, the Supreme Court of Virginia provides a primer on the current vitality of actions for inverse condemnation in VA. Professor Kent Sinclair discusses this key ruling on the interplay of pleading sufficiency standards and substantive law in this area, and the grounds on which inverse condemnation cases can be brought -- matters unclear until this decision was rendered.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Overview & Importance

In *Kitchen v. City of Newport News, 275 Va. 378, 657 S.E.2d 132 (2008)*, the Supreme Court found that a circuit court had wrongly sustained a city's demurrer to a claim for inverse condemnation filed by some 700 plaintiffs based on property damage from flooding allegedly resulting from inadequate municipal drainage infrastructure (along with the fact that the locality had authorized significant property development upstream from the plaintiff homeowners, leading to increased runoff).

The plaintiffs pled specific, factual actions that resulted in a taking of property, which are expressly evaluated in the *Kitchen* decision, and held sufficient to state a claim. An important related issue is when an inverse condemnation claim is "ripe" for adjudication. This issue arises generically, and it also arises because of the interrelation between federal Fifth Amendment "takings" rights and the separate but comparable Virginia cause of action for inverse condemnation. The Supreme Court in *Kitchen* holds that it was error for the trial court to find the claims not "ripe" based on failure to obtain final adjudication of state law claims before pursuing federal law theories.

A further landmark holding in *Kitchen* is that the declaratory remedies structure under Code § 8.01-187 is not the exclusive remedy for claimants making inverse condemnation claims against political subdivisions of the Commonwealth: claims under Article I, Section 11 of the Constitution of Virginia may also be pursued.

Thus the recent decision straddles an interesting blend of issues ranging from constitutional law to torts, declaratory and damage actions, and civil procedure, with exhaustion of remedies tossed into the mix.

Background facts.

In *Kitchen*, approximately 700 plaintiffs filed suit alleging that their properties in three residential subdivisions in a city had been damaged by serious flooding as a direct result of governmental action. They alleged that inadequate drainage infrastructure was maintained by the locality. Further, they alleged that the city's approval of development of other property caused regular and substantial increases in the down-stream flow of water through the subdivisions in which plaintiffs' homes and land are located.

Plaintiffs in this case contended that the city's actions resulted in a taking of their private property without just compensation in violation of the Fifth Amendment of the United States Constitution, and sought damages under 42 U.S.C. § 1983. Such an action may be maintained under governing United States case law in state courts.

A second count pled in *Kitchen* alleged a taking of property by the city without just compensation and sought monetary compensation under Article I, § 11 of the Constitution of Virginia. As is traditional, this claim relies upon an implied contract theory, which is one reason why *sovereign immunity* is no bar to such an action (it is contractual and constitutional in origin).

In a third count the plaintiffs in *Kitchen* sought a declaratory judgment and requested damages for the alleged taking pursuant to Code § 8.01-187.

Litigation Posture and Basic Pleading Requirements. The appeal reviewed by the Supreme Court resulted because the trial court sustained the city's demurrer to these inverse condemnation claims, and leave for plaintiffs to amend their pleading was denied. In the posture, the appellate issue was whether the pleading to which the demurrer was sustained had alleged sufficient facts to constitute "a foundation in law" for the judgment sought: that is, did it merely state conclusions of law or did it plead the elements of a claim. These standards were most recently spelled out in *Hubbard v. Dresser, Inc.*, 271 Va. 117, 122-23, 624 S.E.2d 1, 4 (2006).

As *Hubbard* also established in Virginia, to survive a challenge by demurrer, a pleading must be made with sufficient definiteness to enable the court to find the existence of a legal basis for its judgment. Despite the liberality of presentation which the court will indulge, the complaint must state a cause of action.

A demurrer tests the legal sufficiency of the complaint and can only be sustained if the pleading, considered in the light most favorable to the plaintiff, fails to state a valid cause of action. As many cases have stated, the facts expressly alleged are assumed to be true, along with those fairly viewed as impliedly alleged or reasonably inferred from the facts alleged. A case often cited for this proposition is *Welding, Inc. v. Bland County Serv. Auth.*, 261 Va. 218, 226, 541 S.E.2d 909, 914 (2001).

Introduction to Inverse Condemnation Law. The Supreme Court of Virginia in *Kitchen* gave a succinct and clear summary of inverse condemnation as a cause of action in *Richmeade, L.P. v. City of Richmond*, 267 Va. 598, 602-03, 594 S.E.2d 606, 609 (2004). Under the principles espoused in that summary, an inverse condemnation action is a specific type of proceeding based on a constitutionally created right connected to the taking or damaging of property by the government.

To take or damage property in the constitutional sense sufficient to support a private right of action does not require that the sovereign actually invade or disturb the property. Several decisions stretching back for a century demonstrate that taking or damaging property in the constitutional sense means that the governmental action adversely affects the landowners ability to exercise a right connected to the property. See, e.g., *Prince William County v. Omni Homes*, 253 Va. 59, 72, 481 S.E.2d 460, 467 (1997); *City of Lynchburg v. Peters*, 156 Va. 40, 48-49, 157 S.E. 769, 772 (1931); *Lambert v. City of Norfolk*, 108 Va. 259, 265, 61 S.E. 776, 778 (1908).

An action for inverse condemnation is therefore one seeking redress, in the language of *Richmeade*, "for the government's action in limiting property rights the landowner holds." See also *Burns v. Board of Supervisors*, 218 Va.

625, 627, 238 S.E.2d 823, 825 (1977). Quoting earlier authority, the Supreme Court of Virginia in its recent *Kitchen* decision noted that "the act giving rise to the claim is not an act aimed at the property, but rather an act that limits the landowners ability to exercise his property rights without paying the landowner for that limitation."

Applying the traditional Virginia demurrer standards to this inverse condemnation context, the Court in *Kitchen* holds that to avoid dismissal upon demurrer plaintiffs were required to plead "sufficient facts to constitute a foundation in law for the judgment sought, and not merely conclusions of law, alleging government action limiting property rights the landowner holds."

Analyzing the pleading before the Court in *Kitchen*, it was found that the three counts plainly alleged such facts sufficiently to survive the demurrer, including actions, causation, and damage effecting a taking of Plaintiffs private real and personal property for public use. It noted that that the motion for judgment contained more than sufficient allegations of regularly recurring flooding to have survived demurrer even on that point. The three counts sufficiently stated a cause of action for inverse condemnation in light of sixty-eight (68) separate paragraphs of allegations covering some nineteen (19) pages of text. The Supreme Court agreed with the plaintiffs that these averments were far more particularized and specific than the threshold pleading requirements for a sufficient complaint in Virginia, citing *Burns*, 218 Va. at 629, 238 S.E.2d at 826; and *Bell Atlantic-Virginia, Inc. v. Arlington County*, 254 Va. 60, 486 S.E.2d 297 (1997)). It further agreed with the plaintiffs' contention that circuit court, which in effect ruled that specific allegations of when, how, and to what extent the flooding occurred were required, imposed an unwarranted and heightened burden of pleading specificity. The Court commented that specific questions concerning "the frequency, regularity or duration of the flooding, and whether all or only some of the same parcels of real estate were affected" were simply not relevant to whether the inverse condemnation cause of action had been sufficiently pled to defeat the demurrer: " While those items may be items of evidentiary proof at trial, none was necessary for purposes of the cause of action being sufficient to survive demurrer."

Thus the Court held in *Kitchen* that the plaintiffs had not pled mere conclusions of law, but had in fact alleged "specific, factual actions of the city which resulted in a taking of property." And the Court found that a pleading of that nature "meets the requirements for stating a cause of action for inverse condemnation." Thus sustaining a demurrer to these allegations was erroneous.

Fifth Amendment and Exhaustion of Federal Remedies. An important secondary point in the *Kitchen* decision addressed the issue with respect to the one of the three counts that had been pled under the Fifth Amendment. The trial court had found that this claim was not ripe for consideration. Rejecting that view, the Supreme Court of Virginia noted that federal case law does not accept the contention that plaintiffs are forbidden from simultaneously advancing their federal claims in state courts.

Thus the Supreme Court of Virginia holds in *Kitchen* that the plaintiffs in that litigation were "not required to seek a remedy under their state law counts without success before the circuit court could consider the Fifth Amendment claim." The Court noted that there is simply "no Virginia rule requiring that result." As a result, these plaintiffs were held to be entitled to pursue Fifth Amendment claims *simultaneously* with the state law claims. In that sense, the state law claims were "ripe" for adjudication even before the federal claim was "exhausted" by being brought to final adjudication.

Virginia Constitutional Claim and Declaratory Procedure. Article I, Section 11 of the Constitution of Virginia provides that private property shall not be taken or damaged for public use without just compensation. The Court has traditionally held that this section is self-executing and permits a property owner to enforce his constitutional right to just compensation in a common law action, not as a tort action but rather as a contract action which is not barred by the doctrine of sovereign immunity. See *Bell Atlantic-Virginia*, 254 Va. at 62, 486 S.E.2d at 298; *Jenkins v. County of Shenandoah*, 246 Va. 467, 470, 436 S.E.2d 607, 609 (1993); *Burns*, 218 Va. at 627, 238 S.E.2d at 825.

Procedurally, Code § 8.01-187 affords a statutory remedy to determine compensation for property taken or

damaged. It provides that if it is determined in a declaratory judgment proceeding that a person's property has been taken or damaged within the meaning of Article I, Section 11 of the Constitution of Virginia and compensation has not been paid or any action taken to determine the compensation within 60 days after entry of that judgment order or decree, the court may, upon motion of such person after reasonable notice to the adverse party, enter a further order appointing condemnation jurors to determine the compensation.

Prior case law construing Code § 8.01-187 had left open the issue whether this remedy is exclusive when a claim is made against the Commonwealth or one of its political subdivisions entitled to sovereign immunity as opposed to a private entity with powers of eminent domain. It was held that Code § 8.01-187 is a statutory remedy which does not preempt common law remedies against a non-sovereign entity vested with the power of eminent domain unless the statute, expressly or by necessary implication, so provides.

The issue was squarely presented in *Kitchen* and resolved. The Supreme Court of Virginia holds that Code § 8.01-187 is *not* the exclusive remedy for claimants making an inverse condemnation claim against a political subdivision of the Commonwealth. The Court found that the "self-executing" nature of the provisions of Article I, Section 11 of the Constitution of Virginia and the Legislature's enactment of Code § 8.01-187 does not change that analysis or evidence an intent on the part of the General Assembly to limit the right to make the constitutional takings claim. The Court stated that Code § 8.01-187 disturbs no vested rights and creates no new obligation. It merely supplies another remedy to enforce existing rights.

The Supreme Court was assured that the General Assembly was well aware of earlier decisions on the constitutional cause of action, and holds in *Kitchen* that if the Legislature had intended the statutory proceeding to supersede ordinary causes of action, it would have said so on the face of the statute. It did not, and, as the Court also says frequently, "it will not be assumed that the omission was an oversight." Indeed, the Court felt that to read the statute otherwise would be to add language to the statute.

Summary. Thus, Code § 8.01-187 does not operate in Virginia as the exclusive remedy for an inverse condemnation claim against the Commonwealth or one of its political subdivisions. The takings claim under Article I, Section 11 of the Constitution of Virginia and the statutory takings claim are both claims which may be pursued. Combined with the reemphasis on the liberality of pleading standards as applied to stating this cause of action, the recent decision in *Kitchen* breathes new life into this cause of action in Virginia, makes it easier for plaintiffs to pass the hurdle of a demurrer, and makes it clear that exhaustion of federal claims is not a prerequisite to relief on the Virginia claims.

Virginia Cross-References Research Leads. For further analysis of the topics of Virginia law addressed herein, please consult the following sources:

On eminent domain and condemnation actions generally, see **Charles E. Friend and Kent Sinclair**, Virginia Pleading and Practice, Chapter 27 and § 27.22 (Condemnation and Eminent Domain), and Virginia Bench Book Civil, Chapter 10 § I (Condemnation).

Concerning declaratory judgment practice in Virginia, see **Charles E. Friend and Kent Sinclair**, Virginia Pleading and Practice (2nd ed.), Chapter 30 "Declaratory Judgments," and **Kent Sinclair & Leigh Middleditch**, Virginia Civil Procedure (4th ed.) § 3.10 Declaratory Relief, and **John Costello**, Virginia Remedies, § 16.09 Declaratory Judgment.

The relationship between condemnation and inverse condemnation (viewing it as the remedy open to a landowner when government action takes property without use of the formal eminent domain mechanisms) is discussed in Michie's Jurisprudence, EMINENT DOMAIN, at e.g., § 3(Definitions and Distinctions), §99 (Generally)

The statute of limitations on inverse condemnation suits is 3 years, owing to its origins as a form of implied contractual obligation to compensate the landowner. See generally Michie's Jurisprudence, LIMITATION OF

ACTIONS § 12.

ABOUT THE AUTHOR(S):

Professor Sinclair, an active member of the Virginia Bar, teaches the program in Virginia Law & Practice at the University of Virginia School of Law. He is Professor of Law and served for many years as Associate Dean of the Law School. He has written more than a dozen books, and is the author of *Sinclair & Middleditch, Virginia Civil Procedure* (4th ed. 2003 and annual supplements), and co-author of *Friend & Sinclair, Virginia Pleading and Practice* (2nd ed. 2007 with annual supplements). Both are treatises on Virginia law published by Lexis Law Publishing. Professor Sinclair is Chair of the Advisory Committee on Rules of Court for Virginia, and has served as Reporter for the Virginia Model Jury Project for a number of years. He has served on the Board of Governors of the Litigation Section of the Virginia Bar Association and the Boyd-Graves Conference on Virginia Law. He edits the *Virginia Court Advance Rules and Practice Service* for Lexis Law Publishing and is a frequent lecturer at continuing education programs for attorneys and Virginia judges. For the past 15 years he has been Reporter and Editor of the *Guide to Evidence in Virginia*, and starting in 2008 he is co-author of *Friend & Sinclair, The Law of Evidence in Virginia*.



36 of 79 DOCUMENTS

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Grable and Shatz on Role of Airport Land Use Commission in Muzzy Ranch CEQA Case

2008 Emerging Issues 2695

Roger A. Grable and Benjamin G. Shatz on California Supreme Court Defines Role of Airport Land Use Commission in CEQA Case, *Muzzy Ranch Co. v. Solano County Airport Land Use Commission*, 41 Cal. 4th 372 (June 21, 2007)

By Roger A. Grable and Benjamin G. Shatz

August 13, 2008

SUMMARY: The California Supreme Court held in the Muzzy Ranch case that the airport land use plan restricting residential development in a 600-square-mile area surrounding Travis Air Force Base fell within a CEQA exemption for projects that had no potential to cause a significant effect on the environment, and thus environmental review was not necessary. This commentary examines the Muzzy Ranch decision and its impact on future land use planning.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Overview

Two weeks ago* the California Supreme Court issued a unanimous ruling in a case under the California Environmental Quality Act (CEQA): *Muzzy Ranch Co. v. Solano County Airport Land Use Commission*, 41 Cal. 4th 372 (June 21, 2007). The Courts opinion, written by Justice Werdegar, found that the Solano County Airport Land Use Commissions airport land use plan restricting residential development in a 600-square-mile area surrounding Travis Air Force Base fell within a CEQA exemption for projects that have no potential to cause a significant effect on the environment, and thus environmental review was not necessary.

Analysis

The case began in 2002 when the Commission adopted an airport land use plan that set forth land use compatibility policies applicable to future development near the Air Force base. The Commission determined that the plan was not a project subject to environmental review under CEQA and that the plan fell within the common sense exemption of the CEQA Guidelines. The owner of 1,000 acres affected by the plan, Muzzy Ranch Co., filed a petition to have the restrictions removed, arguing that the Commission did not comply with CEQA procedures in enacting the plan. The trial court denied Muzzys petition, but the Court of Appeal reversed. The Supreme Court then granted review, and now has reversed the Court of Appeal.

The Supreme Court rejected the Commissions argument that its plan was not a project under CEQA. Although the Commissions plan did not effect a direct physical change on the environment, it still might affect the environment indirectly -- perhaps by shifting development to nearby, unaffected parcels. Thus the plan could not escape CEQA review on the basis that it did not qualify as a project.

The Court, however, found the plan exempt from CEQA on a different basis: The plan qualified under the common sense exemption of the CEQA Guidelines (CEQA Guidelines § 15061(b)(3)). This exemption applies [w]here it can be seen with certainty that there is no possibility that the activity in question may have a significant effect on the environment. Because the plan simply incorporated existing county general plan and zoning provisions, the plan did not have any effect on the environment that was not already impacted by existing land use regulations.

While not otherwise surprising, the Courts opinion contains three aspects that may be of significance in the future.

The first aspect is the defining of the jurisdiction of Airport Land Use Commissions and the effect of the adoption of airport land use plans. The State Aeronautics Act creates an Airport Land Use Commission in every county that contains an airport. These commissions are responsible for adopting comprehensive land use plans that provide for the orderly growth of airports and the areas surrounding airports. In the past there has been a tendency to afford these plans little weight, as cities and counties had the ability to approve development that was inconsistent with the airport land use plan by a two-thirds vote of their governing bodies. Indeed, the Solano Airport Land Use Commission argued that its plans were merely recommendations, requests, or advice to the affected jurisdictions, which supports the position that the adoption of the plan was not a project within the meaning of CEQA.

The Supreme Court strongly disagreed, pointing to *Government Code Section 65302.3*, which provides that a countys or citys general plan, as well as any applicable specific plans, must be consistent with the Airport Land Use Commissions plan. The Supreme Court acknowledged that local agencies could override a commissions determination that a proposed action of the local agency is inconsistent with the land use plan by a two-thirds vote of their governing body. In doing so, however, the Supreme Court noted that the local agency is required to make specific findings in overriding the commissions determination, including a finding that the proposed action is consistent with the State Aeronautics Act. The Supreme Court concluded that under the State Aeronautics Act, an airport land use plan can operate like a multi-jurisdictional general plan to trump the land use authority of local agencies. Consequently, the adoption of an airport land use plan, like the adoption of a general plan, is a project under CEQA.

Questions for the future include whether Airport Land Use Commissions will interpret the Supreme Courts opinion as an expansion of their authority and what will be the impact on local land use planning? The commissions have broad authority to define the physical scope of their plans. Will Airport Land Use Commissions now seek to expand their land use planning authority, bolstered by the Supreme Courts ruling?

A second aspect of the opinion is the Supreme Courts clarification that, contrary to the Commissions argument, an agency is required to consider environmental effects outside of the jurisdiction of the agency to the extent they are affected by a proposed project. The Court distinguished its earlier ruling in *Sierra Club v. California Coastal Commission*, 35 Cal. 4th 839 (Cal. 2005), which addressed whether the Coastal Commission is required to consider impacts of projects outside of the coastal zone when exercising its permitting authority within the coastal zone. The Court held that *Sierra Club* is not applicable to the CEQA analysis because that case dealt with statutory provisions that placed geographical limits on the Coastal Commissions authority. In contrast, nothing in CEQA imposes any per se geographical limit. While also not surprising, this does put to rest potential issues raised by the *Sierra Club* case.

The third aspect of the opinion that may have future implications is that the Supreme Court was willing to overlook the fact that in filing the notice of exemption for the land use plan, the Commission cited no evidence and instead merely stated a legal conclusion that Section 15061 of the CEQA Guidelines applied. The Supreme Court noted that the Commissions decision to find the adoption of the land use plan within the CEQA common sense exemption must be supported by substantial evidence in the record and that the burden was on the Commission to cite to such evidence.

The Supreme Court, however, looked to the record itself to find that substantial evidence did exist to support the Commissions determination. The Court noted that CEQA does not require detailed or extensive fact-finding in order to determine if the common sense exemption applies to a project. In this regard, the Court noted that it is relevant, although by no means determinative, that future effects will themselves require analysis under CEQA. The Supreme Court also gave great weight to the fact that the CEQA Guidelines provide for streamlined review of projects consistent with existing general plans and zoning. (Section 15183.) This portion of the opinion is certain to be cited by those seeking more expedited review and less formal fact-finding in the CEQA process.

*Editor's Note: "Two weeks ago" refers to June 21, 2007.

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Roger A. Grable, counsel in the law firm of Manatt, Phelps & Phillips, LLP, focuses his practice on land use and entitlement law and specializes in development processing, development agreements, CEQA, subdivision, and vested rights issues. He has served as the City Attorney for the cities of Irvine, La Palma, San Clemente, and Laguna Beach. Mr. Grable has lectured on and authored numerous articles on planning, zoning, environmental, and subdivision law. He is a past President of the Orange County Bar Association and a former Chairman of the State Bar Resolutions Committee. Mr. Grable has received B.A. in 1967 from Brigham Young University and his J.D. in 1970 from the University of California Hastings College of the Law, where he was Order of the Coif, a member of the Thurston Society, and Editor of the *Hastings Law Journal*.

Benjamin G. Shatz, counsel in the law firm of Manatt, Phelps & Phillips, LLP, is certified as an appellate law specialist by the California State Bar Board of Legal Specialization and has briefed more than one hundred civil appeals, writs, and petitions to the U.S. Supreme Court, U.S. Courts of Appeals, California Supreme Court, and California Courts of Appeal, covering areas of law including insurance, product liability, intellectual property, employment, land use, professional liability, wrongful death, and unfair competition. He served as Law Clerk to the Honorable Robert J. Johnston, United States Magistrate Judge for the District of Nevada, and as Extern to the Honorable Dorothy W. Nelson, United States Court of Appeals for the Ninth Circuit. He has written numerous law review, magazine, and newspaper articles. Mr. Shatz received his J.D., magna cum laude, in 1992 from the Pepperdine University School of Law, where he was Associate Editor of the *Pepperdine Law Review* and Assistant Editor of the *California Supreme Court Survey*.



37 of 79 DOCUMENTS

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Professor Roger Bernhardt on Stone v. Center Trust Retail Properties, Inc.

2008 Emerging Issues 2583

Professor Roger Bernhardt on Stone v. Center Trust Retail Properties, Inc., 163 Cal. App. 4th 608, 2008 Cal. App. LEXIS 807 (May 30, 2008)

By Roger Bernhardt

July 24, 2008

SUMMARY: In this Emerging Issues Analysis by Professor Roger Bernhardt on Stone v. Center Trust Retail Properties, Inc., the court found that a landlord who obtained a judgment of possession in an unlawful detainer proceedings against a restaurant, but allowed the restaurant to continue operating, at which time a customer was injured, had a duty to inspect the premises on entry of judgment and at reasonable intervals thereafter.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: This "bright line" rule creates too many shadows on the issue of a landlords liability for defective premises. If the duty to inspect arises on entry of a judgment of possession, as the opinion in *Stone* holds, does that imply that prior to that time there is no such duty (as this court implied out of its reading of *Martinez v. Bank of America (2000) 2 Cal. App. 4th 883, 98 Cal. Rptr. 2d 576*)? A bright line rule is not much good if the duty is the same on both sides of the line, and the dissent quotes the lease as giving the landlord the right to inspect "at all times."

The dissenting opinions version of the lease gives the landlord the right to reenter--rather than the right to inspect--on default, and perhaps that is the significant feature the majority meant. But in light of Californias statutory prohibition of forcible entry, it is this authors opinion that a landlord has a meaningful right to enter (and alter leased premises) just because its lease says so. A writ of possession entitles a landlord only to instruct a sheriff to dispossess a tenant, not to do so himself or herself.

Our current rule requires a landlord to exercise due care with regard to the premises it owns. That duty of care must be reconciled with the fact that it does not have actual possession of those premises. Even if there is an explicit or implicit right to inspect, it is not clear what a landlord should do when an inspection reveals a danger to the public. Since self-help is prohibited, the landlord cannot padlock the premises on its own but must get judicial assistance. Perhaps knowledge of the illegal after-hours dancing should have led this landlord to call the police, but how would that have led to avoidance of the plaintiffs slip and fall so as to call it lack of due care?

Cross References

Levy et al., California Torts, Ch. 16, *Landlord-Tenant Tort Liabilities*, § 16.11 (Matthew Bender) (discussion of landlords duty of care).

California Real Estate Law & Practice, Ch. 170, *The Premises: Duties and Liabilities* (Matthew Bender).

Westley & Saltz, Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 3, *Rights and Duties of Landlord and Tenant During Tenancy*, 3.12 (landlords duty to repair).

For discussion of the facts, procedures, and holdings in *Stone v. Center Trust Retail Properties, Inc.*, see the July 2008 issue of California Real Estate Reporter (Matthew Bender).

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ABOUT THE AUTHOR(S):

Roger Bernhardt, Professor of Law at Golden Gate University in San Francisco, is author of Bernhardt's California Real Estate Codes (LexisNexis), California Mortgage and Deed of Trust Practice (CEB), as well as numerous books on Property and Mortgage Law for students. He is also Editor of CEB's California Real Property Law Reporter and Bernhardt's Mortgage Law Newsletter. (RBernhardt@GGU.edu)

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38 of 79 DOCUMENTS

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John V. Orth on Hershman-Tcherepnin v. Tcherepnin

2008 Emerging Issues 2584

John V. Orth on Hershman-Tcherepnin v. Tcherepnin, 873 N.E.2d 771 (Mass. App. 2007)

By John V. Orth

July 24, 2008

SUMMARY: John V. Orth explains how a music composer's choice to use the latest will-drafting software instead of consulting a lawyer illustrates the danger that family discord will result.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Orth, John V. *Hershman-Tcherepnin v. Tcherepnin*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

Music professor composes a family feud. When long-time Harvard Music Professor and internationally known composer Ivan Tcherepnin sat down to his computer to write his will, he must have thought he didn't need a lawyer. Using the latest will-drafting software, he certainly succeeded in making a valid will and laying the foundation for a bitter and expensive family feud. Leaving his wife and four children by a prior marriage one-fifth interests each in his house, Tcherepnin stipulated that the widow had the right to remain there for as long as she desires. Disputes between the children and their stepmother led to her locking them out and suing for partition, claiming that she had been given a right to occupy for life. The Massachusetts Probate Court agreed, finding that the will unambiguously devised to the widow a life estate with the exclusive right to reside on the premises and that she and the children shared the remainder. The court then determined the fair market value of the property and allocated it largely to the life tenant. The Appeals Court reversed and held that the will devised the property to the widow and children together as tenants in common. On November 29, 2007, the Massachusetts Supreme Judicial Court granted review, 877 N.E.2d 599 (Mass. 2007), which is still pending.

Life estate and remainder or tenancy in common? No particular words are required to create a life estate, but the testator's intention in this case is unclear. The appellate court surveyed cases from other jurisdictions illustrating interpretations of similar devises as granting either a tenancy in common with merely precatory language concerning occupation or a life estate followed by a remainder.

Lacking any indication that the children's interest was subsequent to the widow's, or that she was obligated to pay taxes and upkeep during her life, the Massachusetts Appeals Court reasonably construed the intention to be to confer

present interests on all five devisees, a fee simple in tenancy in common. Although the widow had a right to partition, she was entitled only to one-fifth in value.

The decision allowed the court to avoid the question whether, if the widow did receive a life estate, it lasted only so long as she chose to remain there. In a footnote the court noted that it did not decide whether a devise of a life estate defeasible by the termination of the recipients desire to occupy the property is defeased by the filing of the petition to partition. *Id.* at 777.

What value would legal advice have added? Without a client interview, it is hard to know what Professor Tcherepnin would have wanted, had he been led to foresee the potential for disagreement between his children and his second wife. Perhaps he would have chosen a devise to her outright, in fee simple. Or a life estate and remainder could have been unambiguously created by a devise in the form to W for life, then to the children, share and share alike. Better, of course, would have been a devise in trust: for the benefit of W for life, then to the children, perhaps making her trustee as well. An experienced lawyer might also have suggested giving the widow a special testamentary power of appointment, allowing her to apportion the remainder among her stepchildren if she saw fit. Legal advice might have kept the family singing in harmony.

For additional discussion of life estates, see Powell on Real Property Ch. 15 (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

For additional discussion of powers of appointment, see Powell on Real Property Ch. 33 (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

For additional discussion of partition and tenancies in common, see Powell on Real Property Ch. 50 (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

ABOUT THE AUTHOR(S):

John V. Orth is William Rand Kenan, Jr. Professor of Law at the University of North Carolina at Chapel Hill, where he has taught for 30 years. He is the recipient of the University's award for excellence in teaching. His undergraduate degree is from Oberlin College, and he has a law degree and Ph.D. in history from Harvard University. He contributes the chapters on concurrent estates to Thompson on Real Property, Thomas Edition, published by LexisNexis, as well as annual articles in the series Reappraisals in the Law of Property, published in The Green Bag. He is the author of *How Many Judges Does It Take to Make a Supreme Court*, and *Other Essays on Law and the Constitution* (2006); *Due Process of Law: A Brief History* (2003); *The North Carolina State Constitution with History and Commentary* (1993); *Combination and Conspiracy: The Legal History of Trade Unionism, 1721-1906* (1991); and *The Judicial Power of the United States: The Eleventh Amendment in American History* (1987). Professor Orth has published numerous law review articles on constitutional law, property law, and legal history. His publications have been cited by federal and state courts, including the United States Supreme Court and the North Carolina Supreme Court.

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39 of 79 DOCUMENTS

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Jaworski on Financial Consumer Hotline Act

2008 Emerging Issues 2550

Robert M. Jaworski on The Financial Consumer Hotline Act of 2007

By Robert M. Jaworski

July 19, 2008

SUMMARY: Mortgage compliance expert Robert M. Jaworski, Esq., explains how daunting a task it can be for consumers and their attorneys to resolve complaints with financial institutions and how The Financial Consumer Hotline Act of 2007 might change that.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Jaworski, Robert M. The Financial Consumer Hotline Act of 2007. LexisNexis Expert Commentary, *(Insert date you accessed the document online)*.

On December 6, 2007, Representatives Mahoney of New York and Frank of Massachusetts introduced H.R. 4332, dubbed the Financial Consumer Hotline Act of 2007 (the Bill). The Bill strives to deal with a problem faced by many consumers in the United States, and even their attorneys, when trying to resolve complaints with their financial institutions. The problem is trying to figure out which regulator has supervisory jurisdiction over the particular financial institution involved.

The problem stems from the fragmented system of banking regulation that exists in the United States. First, there are both federally-chartered banks, which are supervised exclusively by federal bank regulators, and there are state-chartered banks, which are supervised jointly by state bank regulators and the Federal Deposit Insurance Corporation (FDIC). There are also bank holding companies, which are supervised by both the Federal Reserve Board and, to some extent, state bank regulators. In addition, credit unions have their own regulator. Federally-chartered credit unions are regulated by the National Credit Union Administration (NCUA), and state-chartered credit unions are regulated by state banking or credit union regulators and the NCUA.

Complicating matters further, there is no *one* federal regulator which oversees the activities of all federally-chartered banks. Instead, national banks (which, typically, include the word national in their names, or the words national association or the initials N.A. after their names) are regulated primarily by the Office of the Comptroller of the Currency; and federal savings associations and federal savings banks (which may have the word savings and/or the initials, F.A. or F.S.B., after their names) are regulated primarily by the Office of Thrift Supervision. The FDIC also has jurisdiction to deal with deposit insurance matters involving these institutions.

Not only that, but there are a variety of other *non-bank* financial institutions which consumers use to meet their financial needs. For example, consumers may obtain loans from non-bank lenders, investment advice or assistance from broker-dealers or insurance products from insurance companies or agencies.

Often, however, these non-bank financial institutions are owned by or affiliated with banks and/or have their own set of regulators. Most licensed lenders, including ones that are owned by bank holding companies, are overseen by state bank regulators or other state regulators. However, licensed lenders that are owned at least 50% by national banks, federal savings associations or federal savings banks (called operating subsidiaries) are regulated by the same regulator that oversees the activities of the parent bank. Broker-dealers, including those affiliated with banks, are regulated by the Securities and Exchange Commission; and insurance companies and insurance agents, including insurance companies that are affiliated with banks and insurance agencies that are owned by or affiliated with banks, are regulated by state insurance regulators.

This is only a thumbnail sketch of the regulatory labyrinth that consumers face when forced to pursue their complaints beyond the bank itself. (Attempting to resolve a complaint directly with the financial institution should always be the consumers first step.) It can be a daunting and extremely frustrating task. Consumers who attempt to seek redress from the wrong regulator may be ignored, rejected or referred to another regulator which may also have no jurisdiction over the institution involved.

By proposing the Bill, its sponsors hope to ride to the rescue of befuddled complainants. If enacted, the Bill would establish a single toll-free telephone number for consumer complaints and inquiries. This toll-free number would be coordinated by the Federal Financial Institution Examinations Council, which is an umbrella organization created to coordinate the activities of all of the federal bank regulators. Associated with this toll-free number would be a system to route consumer complaints and inquiries to the appropriate federal bank regulator or the appropriate federal or state agency to address the consumers issue (if it happens not to be one of the federal bank regulators). If and to the extent practicable, this system must be designed to enable calls to be transferred directly to participating state regulators where appropriate.

The Bill would also require the federal bank regulators: (1) to establish a public interagency website for directing Internet consumer complaints and inquiries to the appropriate federal bank regulator or other appropriate state or federal agency to address the issue; (2) to establish a system to route misdirected consumer complaints to the appropriate federal or participating state regulator; and (3) to submit a report to Congress, within 6 months after the Bills enactment, describing their efforts in these regards.

A hearing was held on the Bill on December 12, 2007. Not surprisingly, consumer advocacy groups expressed support for the Bill as a partial solution to the problem, although they urged Congress to go further to protect consumers. Also not surprisingly (since expressing opposition to the Bill would appear anti-consumer), most of the representatives who testified on behalf of the federal and state bank regulators expressed support for the Bill, provided that it would not supplant any existing consumer help lines established and maintained by the regulator, and provided further, from the states perspective, that it would be multi- directional, *i.e.*, it would reroute consumer complaints not only from federal to state regulators, but also from state to federal regulators.

Considering the non-controversial nature of the Bill, and its clear pro-consumer objectives, chances for passage appear good, assuming of course that it does not get lost in the shuffle of higher priority federal banking legislative efforts to deal with the subprime mortgage lending crisis. The only question is why did it take so long for someone in Washington to come up with this idea.

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40 of 79 DOCUMENTS

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Jaworski on HUDS 2008 Proposal to Reform The Real Estate Settlement Process

2008 Emerging Issues 2535

Robert M. Jaworski on HUDS 2008 Proposal to Reform The Real Estate Settlement Process: Will It Work?

By Robert M. Jaworski

July 16, 2008

SUMMARY: Expert Robert M. Jaworski, Esq. analyzes the merits of HUD's 2008 Proposal for a "new and improved" version of Regulation X, which implements RESPA—including the dramatic change to the form of GFE, modifications to HUD-1/1A Uniform Settlement Statement forms, new "closing script," and revision to the definition of a prohibited required use in connection with a referral to an AfBA.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Jaworski, Robert M. HUDS 2008 Proposal to Reform the Real Estate Settlement Process: Will It Work?. LexisNexis Expert Commentary, *(Insert date you accessed the document online)*.

On March 13, 2008, HUD published its latest proposal (the 2008 Proposal) ⁿ¹ for a "new and improved version of Regulation X, 24 CFR Part 3500, which implements the federal Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 *et seq.* (RESPA). Set forth below is a brief history of HUDs RESPA reform efforts, followed by a summary of the most important provisions of the Proposal and an analysis as to their merits.

Historical Background?Try, Try Again. HUD proposed in July, 2002 to revise Regulation X with the goal of simplifying and improving the mortgage loan origination process and lowering costs to consumers. After reviewing the 40,000 or so comment letters that the 2002 proposal generated, HUD sent a final rule to the Office of Management and Budget (OMB) for review. Under pressure from members of Congress and various segments of the settlement services industry, however, OMB refused to release the final rule, forcing HUD to formally withdraw it in early 2004.

Undaunted, HUD almost immediately began yet another reform effort. Between June, 2004 and early 2006, it engaged in a fact-finding (and, it hoped, consensus-building) effort, in which it held meetings and conducted roundtable discussions with various groups representing all affected groups ? consumers, real estate brokers, mortgage lenders, mortgage brokers, title insurers and agents, attorneys, members of Congress, and others. Over the next two years or so, it digested what it learned from those discussions, developed and tested new forms which it hoped would improve the process and, finally, on March 14, 2008, published the 2008 Proposal.

What Does HUD's 2008 Proposal Do and Is It a Good Idea? HUD's 2008 Proposal is both a scaled-back version of HUDs 2002 Proposal ⁿ² and an aggressive foray into several new and sure-to-be contentious areas. Briefly, the 2008

Proposal would, among other things:

- . **dramatically change the form of Good Faith Estimate (GFE)** that has been in use since 1992 and establish consequences for inaccurate disclosures on that form;
- . **modify the HUD-1/1A Uniform Settlement Statement forms (HUD-1)** in several regards;
- . **create a new Closing Script** to be read aloud by the closing agent to the borrowers at settlement; and
- . **revise the definition of a prohibited required use** in connection with a referral to an affiliated business arrangement (AfBA) and clarify that average-cost pricing and volume discounts that satisfy certain conditions will not be deemed to violate the Section 8 referral fee prohibition.

Each of these proposed changes is discussed in more detail below.

Dramatic Change to Form of Good Faith Estimate (GFE)

HUD wants to throw out its old form of GFE in favor of a new one. The old form (which was a suggested format rather than a mandatory one) is a fairly straightforward, one-page form, with numbered lines for various fees that correspond to the numbered lines on the HUD-1. The proposed new one would be four (4) pages long, cannot be held side-by-side to the HUD-1 to compare fees (although the modified HUD-1 will include line number pointers to the new GFE to facilitate comparisons) and uses some new terms that seem likely not to be well-understood by consumers, such as our service charge, the credit or charge for the specific interest rate chosen, and your adjusted origination charges. This raises a concern at the outset that the new form may not represent an improvement over the old one.

Timing of GFE. Under HUD's 2008 Proposal, the new GFE must be given to consumers within 3 business days after receipt from them of a GFE Application. GFE Applications are received essentially when applicants provide the loan originator with their name, social security number and monthly income, the property address and their best estimate of its value, and the loan amount.

GFE Will Constitute Firm Offer. The new GFE, for which consumers may be charged only a nominal fee, will constitute an offer that essentially must remain open and fixed for at least 10 days. During this 10-day period, presumably, the consumer can shop for a better offer. If the consumer accepts the offer, the terms listed on the GFE must then remain fixed (within specified tolerances, and barring an unforeseen change in circumstances) until closing.

Tolerances. The specified tolerances are (i) 0%, for lender and broker origination fees (if the interest rate has been locked), including discount points/YSPs, and for recording and transfer fees, i.e., these items may not deviate from the figures disclosed on the GFE, and (ii) 10% in the aggregate, for all lender-required settlement services paid to providers selected by the lender or by the borrower from a list provided by the lender, as well as premiums for optional owners title insurance. Other charges will not be subject to any tolerance level, i.e., so long as the GFE estimates for these items are made in good faith, deviations between the actual amounts paid for these items and the estimates will not violate Regulation X.

Our Service Charge/YSPs/Discount Points. HUD's 2008 Proposal attempts to deal with the issue of how best to disclose yield spread premiums paid by lenders to brokers in return for above par loans (YSPs). The new GFE will

require lenders and mortgage brokers to disclose (i) their total compensation, labeled as Our service charge, and (ii) any YSP the mortgage broker expects to receive, labeled as [t]he credit for the interest rate you have chosen [, which] is included in Our service charge or which will 'reduce[s] your upfront charges.'" The amounts listed as Our service charge and the YSP credit may not change once the borrowers interest rate has been locked. Borrowers who wish to obtain a below par loan, rather than receiving a YSP credit, will have to pay discount points to the lender, which will be labeled on the new GFE as [t]he charge for the specific interest rate chosen. Whether consumers will understand these disclosures appears uncertain. n4

Our service charge is supposed to be the sum of all non-third party, loan origination-related charges imposed by the lender and the mortgage broker (if any), including application fees, processing fees, underwriting fees, origination fees, mortgage broker fees, points, etc. By forcing lenders and brokers to lump all of their direct charges into a single all-encompassing originator fee, HUDs 2008 Proposal, in this regard at least, would seem to provide a consumer benefit. For example, it has the potential to make it a little bit easier for consumers to shop for a mortgage loan and a little bit harder for unscrupulous lenders to nickel-and-dime their customers at closing by imposing a myriad of charges that the customers either were not told about or did not notice beforehand.

Cost/Benefit. The costs (financial and otherwise) associated with changing to the new GFE appear to outweigh its perceived benefits. Those benefits, moreover, may be less significant than HUD suggests. The complexity of the new form, the fact that non-portfolio lenders will likely not be able to promise to hold the interest rate disclosed on the GFE (if not locked) for anywhere near 10 days, and the fact that consumers do not seem to shop for mortgage loans the same way that they shop for appliances or new cars, n5 seem to limit the value of the new GFE as an effective shopping tool.

HUD-1 Revisions

Linkage to GFE. HUD's 2008 Proposal links the fees listed on the HUD-1 to the fees listed on the GFE in the following ways: First, by giving the fees the same names on both forms; second, by printing in bold type the fees on the HUD-1 which also appeared on the GFE; and, third, by printing the line number of each fee on the GFE next to its corresponding fee on the HUD-1. It seems that having identical formats for both the GFE and the HUD-1 and requiring all lenders to use that format would be a better alternative than what HUD has proposed.

Title Agent Compensation. HUD has included a new line 1113 on its revised HUD-1, titled Agents portion of the total title insurance premium. The addition of this line will seemingly require title agents, for the first time, to disclose the portion of the title insurance premium that they will retain. Along with the mandate that title agents read the Closing Script aloud to the borrower during the closing (discussed further below), this will likely put significant downward pressure on title agent profits.

Closing Script

HUD's 2008 Proposal requires that a Closing Script, which HUD envisions will be prepared by the lender, be read aloud at the closing by the closing agent. Its purpose is to explain to the borrowers the loan terms that they are actually receiving, whether the fees they are paying are consistent (i.e. within the allowable tolerances) with the fees disclosed on the GFE, and whether the terms of the loan they are receiving are consistent with the terms promised on the GFE.

This requirement raises numerous issues. For example, how will it be effectuated in escrow states where there are no in-person closings? How will it impact title agent profitability? Will title agents who comply with it be at risk of being accused of engaging in the unauthorized practice of law? And will it serve to place title agents in the awkward (and thankless) position of referee between borrowers and lenders?

Average-Cost Pricing/Volume Discounts/Required Use

HUD's 2008 Proposal seeks to clarify the impact of Section 8 upon certain industry practices, specifically (a) average cost pricing, where the prices paid by the loan originator for third party services may differ from one loan to the next but the loan originator charges each borrower the same average price; (b) volume discounts, where the loan originator negotiates discounts based on volume from third-party settlement service providers; and (c) discounts offered to customers as an incentive to use affiliated settlement service providers for needed services.

Average Cost Pricing. The 2008 Proposal indicates that this practice, so long as the costs are averaged according to methods set forth in the Proposal, will not be deemed to violate Section 8, despite that it will cause some borrowers to pay more for the particular settlement service than the actual amount charged for that service by the third-party settlement service provider. This clarification should reduce administrative burdens faced by lenders having to account for actual settlement service charges incurred on behalf of each of their borrowers and result in cost savings which can then be passed on to consumers.

Volume Discounts. The 2008 Proposal also indicates that negotiating discounts for third party settlement services based on volume will not be deemed to violate Section 8 so long as the borrower is not charged more than the discounted price. In other words the full amount of the negotiated discount must be passed through to the borrower. This caveat, however, acts to remove any incentive that a lender might have (beyond, perhaps, gaining a slight competitive edge) to conduct such negotiations.

Affiliated Business Incentives. The 2008 Proposal would also amend HUD's existing definition of required use to specifically include a situation where the borrower becomes eligible to receive a discount, rebate or other economic incentive only if he/she uses a particular settlement service provider. This amendment would appear to outlaw the current practice of some new home builders to offer upgrades or discounts on the sales price or to pay all or some of the buyers closing costs if the buyer/borrower agrees to use the home builders affiliates for needed settlement services. While some of these offers may not provide consumers with the savings they think they are getting (because those savings may be made up by higher costs elsewhere in the transaction), many are no doubt legitimate. But the 2008 Proposal outlaws both good and bad offers, without attempting to differentiate between them. This can only hurt consumers.

HUD's 2008 Proposal also indicates that an offer of a combination of settlement services at a price that is less than the sum of the prices for each such service would not be deemed to constitute a required use so long as the borrower may elect not to accept the offer. While this is not a change from the current rule, it seems somewhat inconsistent with the prohibition on builder incentives discussed above and thus likely to lead to confusion.

Timetable for HUD's 2008 Proposal to Become Effective

The comment period set forth in the 2008 Proposal is 60 days after publication, i.e., comments were to be accepted only until May 13, 2008. Under intense pressure from the industry and others, however, HUD very reluctantly agreed to extend the comment period for an additional 30 days until June 12, 2008. In doing so, however, HUD has reiterated its intention to finalize the rule before the end of the current Administration.

If HUD's last try at RESPA reform provides any indication, it is likely that HUD will have received thousands of comments to the 2008 Proposal before its June 12, 2008 deadline. Nevertheless, in HUD's Semi-Annual Regulatory Agenda, released on May 5, 2008, HUD indicated that it expected to take final action on the rule by October, 2008. This is an extremely tight timetable for a rule of this significance, and seemingly an unrealistic timetable if the goal is to produce a workable rule that actually helps consumers and provides clear guidance to those who must comply with it.

For additional coverage of RESPA, see discussion by Robert M. Jaworski, Esq. in Powell on Real Property Ch.

37A, *The Impact of the Truth in Lending Act and RESPA Upon Real Estate Financing*, (Michael Allan Wolf ed., LexisNexis Matthew Bender).

[Return to Text](#)

n1 . The 2008 Proposal is found at Docket No. FR-5180-P-01, *73 Fed. Reg. 14030* (Mar. 14, 2008).

n2

[2]. HUDs 2008 Proposal does not include a packaging element, which was at the heart of HUDs 2002 proposal and generated much of the controversy over that proposal.

n3 . Unless locked, the interest rate and certain items that depend on the interest rate need not remain fixed beyond a date specified on the GFE by the originator.

n4

[4]. HUD commissioned an iterative testing process the results of which led it to believe that consumers will understand the new GFE disclosures.

n5 . Issues of convenience and personal trust seem to play a far more important role in a consumers decision whether or not to apply to a particular lender for a mortgage loan than disclosures as to cost.

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41 of 79 DOCUMENTS

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Michael T. Callahan on Nelson v. City of Horn Lake

2008 Emerging Issues 2551

Michael T. Callahan on Nelson v. City of Horn Lake, 2007 Miss. LEXIS 636

By Michael T. Callahan

July 16, 2008

SUMMARY: Get expert commentary from Michael T. Callahan on whether a low bidder on a public construction project had a property interest in the award of the contract.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Callahan, Michael T. *Nelson v. City of Horn Lake*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

Nelson v. City of Horn Lake confronted whether a low bidder on a public construction project had a property interest in the award of the contract. The Supreme Court of Mississippi determined in *Nelson* that the lowest bidder did not obtain a constitutionally protected property interest in a contract as a result of being the lowest bidder on a publicly bid project. This is important because most contractors believe if they submit the low bid, they are entitled to the award. Construction attorneys in the U.S. should expect enquiries from disappointed low bidders on public projects and be able to provide a realistic prediction on the success of any action to claim the disappointed bidders rightful award.

The majority of courts have held that a disappointed bidder generally does not possess a property interest when the contract is not actually awarded to it. A property interest in a competitively bid public procurement depends upon a legitimate claim of entitlement. When a public agency seeks competitive bids on a project, its solicitation does not create a protected property interest or a legitimate claim of entitlement in the low bid. However, such entitlements may be derived from statute, legal rule, or mutually explicit understanding and stemming from a source independent of the federal Constitution such as state law. Michael T. Callahan, 2 Procurement of Construction and Design Contracts 862 (2005) (citing *Interior Contractors*, 185 F. Supp. 2d 1216 (citing *Board of Regents v. Roth*, 408 U.S. 564 (1972))).

In *Nelson v. City of Horn Lake*, the City of Horn Lake solicited bids for a sewer improvements project. Nelson Plumbing Co. submitted the lowest bid on the sewer project in the amount of \$2,294,035.50. The City elected to award the contract to Freeland & Lemm Construction Co., which had submitted the second-lowest bid, but only some \$4,700 higher than Nelson. The City based its award to a higher bidder on the fact that Nelson had received complaints regarding its work on other corporate and municipal projects in the past and that the City itself had problems with Nelson during the construction of its City Hall. Nelson submitted a protest letter to the Mayor and city clerk, but the City affirmed its decision to award the contract to second lowest bidder. Nelson filed an appeal with the local circuit

court. After the circuit court dismissed Nelson's complaint, Nelson appealed to the Supreme Court of Mississippi, arguing that it had a property interest in the sewer project contract that attached once it acquired status as the lowest bidder.

In *Nelson v. City of Horn Lake*, the disappointed bidder identified the statute or rule that gave it entitlement to an award, a Mississippi statute that required a city to place on its minutes detailed calculations and a narrative summary when accepting a bid other than the lowest bid submitted. The statute stated:

If any governing authority accepts a bid other than the lowest bid actually submitted, it shall place on its minutes detailed calculations and narrative summary showing that the accepted bid was determined to be the lowest and best bid, including the dollar amount of the accepted bid and the dollar amount of the lowest bid. *Nelson* at *8 (citing Miss. Code Ann. § 31-7-13(d)(i) (Rev. 2005)).

The term "detailed calculations" in the Mississippi statute required, at least, that "the dollar amount of the accepted bid and the dollar amount of the lowest bid" be included in the governing authority's minutes.

But according to the Mississippi Supreme Court, Nelson's bid was not rejected on considerations to which "detailed calculations" were attributable, but for the reasons described under the "narrative summary" requirement of the statute. When awarding contracts, a governing authority may consider a bidder's "responsibility" concerning matters that relate to the prompt and efficient performance of a contract, including the bidder's honesty and integrity, skill and business judgment, experience and capability of performing the contract, conduct under previous contracts, and the quality of previous work. Callahan, 1 Procurement of Construction and Design Contracts 183-184.

The City of Horn Lake's advertisement for bids stated that the contract would go to "the lowest responsive, responsible Bidder." The term "responsible" was not limited to financial resources and ability; all matters that related to a bidder's prompt and efficient performance of the contract were material to a bidder's "responsibility," including the bidder's honesty and integrity, skill and business judgment, experience and facilities for performing the contract, conduct under previous contracts, and the quality of previous work.

The City's resolution, as incorporated into the City's minutes, stated that the City had decided not to award the sewer project contract to Nelson based on numerous complaints regarding its prior work and the City's own previous difficulties with Nelson in the construction of City Hall. These were appropriate considerations in determining the "responsibility" of a bidder.

The City also reserved the right in its solicitation to investigate bidders "to determine the ability of the Bidder to perform the work," as well as the "right to reject any bid if the evidence submitted by or investigation of such Bidder fails to satisfy the [City] that such Bidder is properly qualified to carry out the obligations of the Contract and to complete the work contemplated therein." *Nelson*, at *10.

Nelson argued that complaints concerning his payment disputes with previous suppliers should not have been considered by the City because these suppliers were protected by Nelson's payment bond. A payment bond under Mississippi statutes served in lieu of any equity or trust in favor of materialmen and laborers. *Nelson* at *17-18 (citing Mississippi Code Annotated Section 85-7-185 (Rev. 1999); see also *Dickson v. United States Fid. & Guar. Co.*, 150 Miss. 864, 117 So. 245, 248 (1928)). Even though the Mississippi statute afforded protection for "persons furnishing labor or material," neither this provision nor Mississippi case law prohibited a governing authority from considering a contractor's prior disputes with creditors. The aggregate of such disputes might bear upon the contractor's honesty, integrity, business judgment, conduct under previous contracts, and pecuniary ability, all of which have been held to be appropriate considerations in awarding a public contract. *Nelson* at *18 (citing *Parker Bros.*, 68 So. 2d at 284-85).

The City had notified all potential bidders in its advertisement that it retained discretion to award the contract to the lowest responsive, responsible bidder. After its investigation, the City concluded that Nelson did not satisfy this criterion. Because the City's advertisement for bids allowed for consideration of bidders' "responsibility" and because

the City also reserved the right to investigate bidders, the Mississippi Supreme court found that the City had the right to reject Nelson's lowest bid for the reasons set forth in its resolution.

Conclusion. As a result, Nelson did not acquire a constitutionally protected property interest in the sewer project contract as the lowest bidder, and as such, the City did not violate Nelson's substantive due process rights.

Practice Tip. Ask the bidder for a copy of the public agency's solicitation. Be sure to read the Information For Bidders part of the solicitation. The language in the solicitation will almost always explain how the public owner will evaluate the bids and what kind of offer by the bidder will be accepted. As in *Nelson*, many public solicitations will state an intent to investigate bidders to determine each bidder's responsibility.

Compare. *Shepard v. City of Batesville*, 2007 U.S. Dist. LEXIS 1519 (N.D. Miss. January 8, 2007). In *Shepard*, the federal court for the Northern District of Mississippi found that the Mississippi Code section discussed in *Nelson* gave a bidder a protected property interest in projects for which it was the lowest and best bidder. *Shepard*, 2007 U.S. Dist. LEXIS at 27. However, *Shepard* is distinguishable from the facts of the *Nelson* case. In *Shepard*, the plaintiff actually had been awarded various contracts over a two-year period, but had been used for only one project. In *Nelson*, the low bidder was never awarded the contract for the sewer project.

Compare. *Buckley Construction, Inc. v. Shawnee Civic & Cultural Development Authority*, 933 F.2d 853 (10th Cir. 1991). In *Buckley*, while noting that a minority of federal jurisdictions have held that an unsuccessful bidder on a state contract possessed a constitutionally protected property interest, the Tenth Circuit held that whether an unsuccessful bidder on a state contract possessed a constitutionally protected property interest should be decided on a case-by-case basis through review of the implicated state law. The Tenth Circuit also stated that generally when a public agency sought competitive bids on a project, it did not create thereby a protected property interest or a legitimate claim of entitlement in the lowest bidder. The majority of federal courts have held that a disappointed bidder generally did not possess a property interest when the contract was not actually awarded to it.

Compare. *Scott v. Buhl Joint School District no 412*, 123 Idaho 779, 852 P. 2d 1376 (1993), in which the Idaho Supreme Court found that the lowest responsible bidder had a property interest in the contract issued as the result of Idaho's competitive bidding statute.

The low bidder never wins anything but opportunity as a result of submitting the lowest bid on a publicly bid project. Most courts agree that bidders do not have any property rights to the award of a publicly bid project until a contract with the public owner has been signed. And even then the bidder is not yet a winner. At best the lowest responsive and responsible bidder that offers the best value to the public owner has only a small chance to win at the conclusion of the project. Many publicly bid projects overrun their bid amount. But that is a subject for another comment.

Nelson is also interesting because of its insights into Mississippi's state procurement code.

Some state and local governments have formal protest procedures by statute or agency rule, but most do not. Mississippi bid laws do not require a hearing when a governing authority rejects a lowest bid. Rather, Mississippi statute requires the governing authority's minutes to provide "detailed calculations and narrative summary showing that the accepted bid was determined to be the lowest and best bid." *Nelson* at *14 (citing Miss. Code Ann. § 31-7-13(d)(i) (Rev. 2005)). If a party remains dissatisfied with the Mississippi agency's decision, the Mississippi statute sets forth the procedure by which an aggrieved party such as Nelson may appeal the decision. *Nelson* at *14 (citing Miss. Code Ann. Section 11-51-75).

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42 of 79 DOCUMENTS

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Michael T. Callahan on Byron Baker v. Donald W. Speaks

2008 Emerging Issues 2556

Michael T. Callahan on Byron Baker v. Donald W. Speaks, 2008 WY 20, 177 P.3d 803, 2008 Wyo. LEXIS 21 (2008)

By Michael T. Callahan

July 16, 2008

SUMMARY: Get expert commentary from Michael T. Callahan on a decision involving the termination of a construction contract as a result of contractor delays even though the contract had no completion date, schedule, or termination clause.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Callahan, Michael T. *Byron Baker v. Donald W. Speaks*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

In *Byron Baker v. Donald W. Speaks*, the Wyoming Supreme Court dealt with the termination of a construction contract as a result of contractor delays, even though the contract had no completion date, schedule, or termination clause. Many courts have dealt with termination for failure to progress, but almost always the dispute involved a contract with a both a termination clause and a contract completion date. The contract in *Baker v. Speaks* had neither.

Many termination clauses permit termination for failure to progress. A contractor or designer may be terminated for failure to make progress if unable to demonstrate the ability or intention to complete its work within the remaining time required for completion. The American Institute of Architects standard general conditions permits the owner to terminate if the contractor persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials. Federal construction contracts permit termination if the contractor fails to make progress, which threatens completion by the required date in the contract.

Default termination for failure to make progress under the standard federal termination clause was described at length by the Court of Claims in *Universal Fiberglass Corp. v. United States*, 537 F. 2d 393, 1976 U.S. Ct. Cl. LEXIS 12 (1976). To justify default for failure to make progress, the court required the government in *Universal Fiberglass* to show substantively that, at the time of termination, there was no reasonable likelihood that the contractor could complete the contract. Evidence to support termination for failure to progress could include missed contract milestones, information from on-site inspections or past progress reports, and responses to earlier requests for time extensions. Michael Callahan, *Changes Resulting from Termination*, Construction Change Order Claims 2ed 350-351 (M. Callahan ed., 2005) (citing *Danzig v. AEC Corp.*, 224 F.3d 1333, 2000 U.S. App. LEXIS 23731 (Fed. Cir. 2000); see also *Morganti Natl, Inc. v. United States*, 49 Fed. Cl. 110, 2001 U.S. Claims LEXIS 57 (2001) (court affirmed default

termination after contractor failed to demonstrate its ability to make progress to complete work at an extended completion date agreed by the government)).

Failure to progress may also justify termination without either a termination clause or a termination clause that includes a failure to progress reference. Early cases ruled that timely completion must be impossible before terminating a contract for failure to make progress. Current law does not require impossibility, or repudiation or abandonment by the contractors, but a showing of a demonstrated lack of diligence. Termination for default for failure to make progress usually occurs where a contractor is so far behind schedule that completion of the job within the time remaining for performance is unlikely.

In *Byron Baker v. Donald W. Speaks*, Baker agreed to build a 36' by 36' log home for David and Elizabeth Speaks. A three-page contract was signed September 14, 1999. The contract required the home to be "[c]ompleted in a substantial workmanlike manner," but provided no particular time for completion of the home. If no specific date of completion is provided in the contract and time is not explicitly made of the essence, the general rule is that the owner cannot terminate the contract for delays by the contractor until the passing of a reasonable time for performance. 1 construction law § 4.14[4] at 4-132 (Stein Ed. 2008) (citing *Empire Energy Mgmt. Sys., Inc. v. Roche*, 362 F. 3d 1343, 2004 U.S. App. LEXIS 5512 (Fed. Cir. 2004, reh'g denied, 2004 U.S. App. LEXIS 14554 (Fed. Cir. June 25, 2004), in Construction Law Digest, July 2004, Digest No. D003409-US; *Intermetal Fabricators, Inc. v. Losco Group, Inc.*, 2000 U. S. Dist. LEXIS 11622 (S.D.N.Y. Aug. 14, 2000) (contractors termination of subcontractor was justified where subcontractor abandoned work after causing substantial delays); *Drews Co. v. Ledwith-Wolfe Assocs.*, 371 S.E. 2d 532, 1988 S.C. LEXIS 100 (1988)). As the Wyoming Supreme Court had previously stated, "[w]here . . . no time for performance is specified in a contract, the law implies performance must be within a reasonable time, and what is a reasonable time depends upon the circumstances of each case." *Baker*, at **6-7 (citing *G.C.I., Inc. v. Haught*, 7 P.3d 906, 909 (Wyo. 2000)).

In *Lake Steel Erection, Inc. v. Egan*, 61 A.D.2d 1125; 403 N.Y.S.2d 387; 1978 N.Y. App. Div. LEXIS 10815 (1978), the court identified the factors used in determining a reasonable time, including the subject matter of the contract, the situation of the parties, their intention, what they contemplated at the time the contract was made and the circumstances attending performance. Another court held that a reasonable time of performance is such time as is necessary to do conveniently what the contract requires. 1 construction law § 4.14[4] at 4-133 (Stein Ed. 2008) (citing *Yale Dev. Co. v. Aurora Pizza Hut, Inc.*, 95 Ill. App. 3d 523, at 524, 420 N.E. 2d 823, 1981 Ill. App. LEXIS 2484 (1981) (a seventeen-month delay in the case was allowable because of a necessity to rezone and noted that the parties had in the past dealt with similar contracts where rezoning was a concern).

Even without a completion date or a schedule, Speaks grew increasingly concerned about both the pace of construction and its apparent poor quality by the spring of 2000. Speaks met with Baker numerous times during the summer of 2000 regarding the delays. There was a final meeting on August 1st, at which Speaks presented Baker with a written list of incomplete items and asked Baker to commit to a completion date. Baker signed a scheduling document that specified "Date[s] of Completion" for each task. It listed that "Logs" were to be completed by "8/9," "Doors" were to be completed by "8/15-8/17," the "Interior Flooring" was to be completed by "8/13," and the remaining "Electric & Plumbing Fixtures" were to be installed by "8/23." The interior of the home would be completed by the end of August, and the exterior would be completed by September 10th.

Practice Note. Reasonable Time To Perform. Speaks may not have had an attorney when the three-page contract with Baker was signed. By the time Bakers performance caused Speaks concern, Speaks had one. And Speaks had an attorney that recognized that a reasonable time for Baker to perform was too nebulous for the certainty required by Speaks. The attorney had Baker agree to both a completion date and a schedule. These two agreements removed Bakers reasonable performance period and substituted one of certain duration. Any subsequent judicial review would now be presented with evaluating Bakers performance according to a fixed completion date and an identified schedule to measure progress.

By the first week of September, Baker had not completed any activities on the August 1st list. Neither had he provided requested lien waivers from the subcontractors. On September 5th, Speaks, acting through an attorney, sent Baker a letter instructing him to vacate the job site until he provided the requested lien waivers. Baker left the job site after receiving the letter on September 7th.

Speaks filed suit, alleging breach of contract. Baker filed a counterclaim for breach of contract. Baker did not dispute that the parties intended the roof to be completed prior to significant snowfall in the fall of 1999. He also did not dispute that the roof was not completed until March 2000. Baker did not complete any of the items on the list. Rather, Baker asserted that Speaks "could not show a clear failure of performance . . . at the time [Mr. Baker] was expelled from the project." *Baker*, at **9. Baker claimed that Speaks's request that he leave the job site constituted breach of the construction contract. He pointed to a prior case in which a district court stated that "the party first committing a substantial breach of contract cannot complain that the other party . . . fails to perform." *Baker*, at **9 (citing *Williams v. Collins Comms., Inc.*, 720 P.2d 880, 891 (Wyo. 1986)).

Baker's reasoning overlooked the fact that he had already breached the contract by the time Speaks instructed him to cease construction, according to the Wyoming Supreme Court. Baker did so in two ways: by failing to complete construction in a timely manner and producing poor workmanship. Both of these breaches occurred prior to September 5th, when Speaks's counsel instructed Mr. Baker to vacate the job site.

Conclusion. Baker breached the contract by failing to complete the project in a timely manner. The claim that Baker did not timely fulfill his contractual obligations was supported by substantial evidence.

Compare. *Thompson v. Valley Corp.*, 528 N.W. 2d 352, 1995 Neb. App. LEXIS 77 (1995), in which the subcontractor filed suit following its termination by the general contractor. The general contractor had used a critical path method schedule to determine when the subcontractors painting work must be completed in order to complete the project on time. The subcontractors slow work eventually became the critical activity for project completion. The city's project coordinator expressed dissatisfaction with the subcontractors performance and the quality of the subcontractors work to the general contractor. The contractor believed the subcontractor was not proceeding diligently. The general contractor gave the subcontractor a three-day notice as required by the subcontract. When the subcontractor failed to send a work crew to the site, the subcontractor was terminated. Five days later, the subcontractor made a written demand for payment and claimed that it had additional time to complete the work at the time of the termination and that it had substantially completed the project. The general contractor hired another painter who completed the painting. The trial court found that the general contractor had breached the subcontract. The appellate court reversed, holding that under the subcontract, if the subcontractor was not proceeding diligently, the general contractor was entitled to invoke the acceleration provision of the subcontract and terminate the subcontractor, even though time remained for completion of the subcontractors work.

Compare. *Mustang Pipeline Co. v. Driver Pipeline Co.*, 2004 Tex. LEXIS 365, 47 Tex. Sup. J. 461 (April 23, 2004), in which the Texas Supreme Court explained that when time of performance is a material part of a contract, an owner may terminate a contractor when there is virtually no chance that the contractor can complete its work on time. The contractor was to construct 100 miles of a 200 mile pipeline for the owner. During the bidding process, the owner stressed that time was of the essence and that the pipeline construction had to be completed no later than April 30. In response to this time demand, the contractor increased its original bid by approximately ten percent, but was still awarded the contract. The contract stated that all time limits included in the contract were of the essence to the contract, and called for "100 percent completion of the pipeline system no later than April 30, 1997." The contract also required that "sufficient forces and equipment . . . be furnished at all times to adequately perform work with ample margin for emergencies and unexpected events, to carry on the work at a sufficient rate of progress to ensure completion within the time specified in the Contract." The parties agreed on a fourteen-week schedule, working eleven hours per day, seven days a week. Fifty-eight days into the ninety-eight day construction schedule, the contractor had completed only fifteen miles of pipeline and suspended operations. The contractor contended that extensive rains delayed the project soon after work began. Although the contractor had workers, equipment and supervision on the job site, it accomplished only

minimal pipeline construction and was behind schedule. The parties disputed whether the contractor could have accomplished more by using different equipment or reassigning crews to work on drier areas. The owner terminated, then sued the contractor for breach of contract. The contractor countersued, alleging that the owner wrongfully terminated the contract.

When the owner realized the contractor was behind on the construction schedule, it asked for assurances from the contractor that the work would be completed by the deadline. The owner also requested a plan from the contractor on how it would finish the project by the end of April. It recognized the unseasonably wet conditions, but offered suggestions to the contractor about how it might expedite construction. The contractor never provided a revised plan on how it would attempt to meet the construction schedule. When the owner terminated the contract, it had approximately forty days before the deadline to complete construction on eighty-five miles of pipeline. At the point at which the owner terminated the contract, there was virtually no chance that the contractor would have been able to complete the construction on time. As a matter of law the contractor committed a material breach. The owner was thereafter discharged from its duties under the contract.

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43 of 79 DOCUMENTS

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Bernhardt on California Golf v. Cooper

2008 Emerging Issues 2523

Professor Roger Bernhardt on California Golf v. Cooper, 163 Cal. App. 4th 1053, 2008 Cal. App. LEXIS 850 (June 9, 2008)

By Roger Bernhardt

July 14, 2008

SUMMARY: This Emerging Issues Analysis discusses how to measure damages after the breach of an agreement to buy real property in a foreclosure sale.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: These defendants were ordered to restore the interpleaded funds to court in order for the trial court to measure the plaintiffs damages, but the opinion does not state how those damages should be calculated.

The original trustee sale was made for \$957,000 and the resale was at \$600,000, with a mathematical difference between them of \$357,000. However, the difference between sale price and resale price is generally the measure employed for sales of *personal* property. Pursuant to California Civil Code § 3307, "[t]he detriment caused by the breach of an agreement to purchase an estate in *real* property is deemed to be the excess, if any, of the amount which would have been due to the seller under the contract over the value of the property to him or her . . . (emphasis added). This is understood to mean the difference between contract price and market value at the time of breach, rather than the difference between sale and resale price at a later date. That formula could limit the damages to only \$1, the amount of the next highest bid (made by the beneficiary at the original sale), unless the beneficiary could produce evidence of a lower market value at the time of that sale (a measure somewhat comparable to what might be reached at a fair value hearing when a deficiency judgment against a trustor is sought after a judicial foreclosure sale).

To apply the resale measure in the trustee sale context may also lead to enabling a beneficiary to set its own measure of damages where, as seems to have been the case here, there is no competitive bidding at the second trustee sale and the beneficiary is the sole bidder. A beneficiary would be well advised to have an appraisal accompanying its bid.

There is currently no clear rule covering this situation.

Cross References

For coverage of nonjudicial foreclosure sales in California, see California Forms of Pleading and Practice, Ch. 555, *Trust Deeds and Real Property Mortgages*, § 555.57 (Matthew Bender).

For detailed coverage of the procedures involved in nonjudicial foreclosures, including discussion of the initiation of proceedings, notices of default, notices of sale, and damages, see California Real Estate Law & Practice, Ch. 123, *Nonjudicial Foreclosure* (Matthew Bender).

For a procedural guide to conducting a trustees sale under California Civil Code § 2924h, see California Legal Forms--Transaction Guide, Ch. 25D, *Foreclosures*, § 25D.125 (Matthew Bender).

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44 of 79 DOCUMENTS

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Bernhardt on Lange

2008 Emerging Issues 2501

Professor Roger Bernhardt on Lange v. Schilling, 2008 Cal. App. LEXIS 915 (May 28, 2008)

By Roger Bernhardt

July 7, 2008

SUMMARY: Get expert commentary on this California appellate court decision, which held that seeking mediation is a condition precedent to the recovery of attorney fees under Paragraph 17A of the standard California residential property purchase agreement.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: It appears that the California Association of Realtors (CAR) has drafted the attorneys fees clause in their real estate purchase contracts that now truly mandates buyers or sellers suing each other to seek mediation first in all cases. Good excuses will not be enough.

This provision is also an important shield for brokers, who are often included as additional parties in litigation between the principals. Since the attorneys fees clause in the CAR real estate purchase and sale agreement does not name the brokers as beneficiaries of it, the agreement therefore affords no basis for either a buyer to recover attorneys fees from the sellers broker, or for a seller to recover such fees from the buyers broker. This is the case even if their underlying claims are successful and attorneys fees are awarded against the principle.

In this case, the failure to mediate first entirely destroyed the buyers right to claim such fees from the sellers or from anyone else. However, it is difficult to ascertain just how liability for such fees could have been transported over from the sellers to their broker under this clause even if the buyers had complied with the mediation precondition. That would seem to be creating a derivative liability with no underlying support for it. It is unlikely that a buyer can recover attorneys fees from a sellers broker when the attorneys fees clause does not make the broker liable for them, whether that buyer is seeking them directly or as an assignee of the sellers, as was the case here.

There is often an attorneys fees clause in the listing agreement executed between a seller and broker. This can, in a proper case, make a broker liable for such fees. However, it is again difficult to see how that clause could be utilized to make a sellers broker liable for attorneys fees to the buyer. Furthermore, the typical attorneys fees provision in the listing agreement includes the same mediation prerequisite that appears in the standard purchase and sale agreement.

Cross References

California Forms of Pleading and Practice, Ch. 174, *Costs and Attorney's Fees*, § 174.53 (Matthew Bender).

For specific coverage of the recovery of attorneys fees in the context of a purchase and sale of real property, see:

. California Real Estate Law and Practice, Ch. 71, *Real Property Purchase and Sale Agreements*, § 71.08[7] (Matthew Bender).

. California Real Estate Law and Practice, Ch. 74, *Buyers Remedies in Actions Involving Agreements of Sale*, § 74.74 (Matthew Bender).

. California Real Estate Law and Practice, Ch. 75, *Sellers Remedies in Actions Involving Agreements of Sale*, § 75.40[7] (Matthew Bender).

See generally California Legal Forms Transaction Guide, Ch. 23, *Agreements to Sell Real Property* (Matthew Bender).

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45 of 79 DOCUMENTS

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Bernhardt on Steiner

2008 Emerging Issues 2468

Professor Roger Bernhardt on Steiner v. Thexton, 163 Cal. App. 4th 359, 2008 Cal. App. LEXIS 784 (May 28, 2008)

By Roger Bernhardt

July 3, 2008

SUMMARY: Get expert commentary on this California appellate court decision, where an agreement titled Real Estate Purchase Contract that gave the buyer the right to terminate the transaction at any time at his sole discretion and was not supported by any consideration was held to be an optional contract rather than an enforceable option to purchase property.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Bernhardt, Roger. *Steiner v. Thexton*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

The buyer in this action, a real estate developer, sought specific performance of a real estate sales contract. The buyer made it too obvious to the court that the agreement was a disguised option not supported by consideration, rather than a bilateral contract, by including in the document the provision stating that he had absolute and sole discretion . . . not to continue in it during the three years of its existence. It is very likely that both the trial and appellate courts would have reached the same conclusion even without that language, but it would have required more work and a closer, probably step by step analysis of all of the provisions of the contract to decide that in fact the buyer was not obligated to do anything at all unless he elected to do. The quoted provision may have merely saved the court the effort of reaching the same result by a more tedious route, but not necessarily. Other courts might have reached opposite conclusions, based upon the reported opinions cited but rejected in this decision.

This buyer could have created an arrangement for the purchase of the sellers property that was enforceable even though conditional. It should have, at the very least, included a stated obligation to perform some of the work that the buyer apparently intended to do anyway. It should probably have additionally provided that this promised work was intended to benefit the seller as well as the buyer and was intended by both parties to constitute consideration.

The arrangement, drafted as this one was, put the buyer in the worst possible situation. He was the one to do all of the work over the next three years while the seller was free to wait until the last minute, reap the benefits of that work, and then withdraw.

Cross References

For a discussion of the facts, procedures, and holdings in this case, see the July 2008 issue of California Real Estate Reporter (Matthew Bender).

The specific performance remedy applicable to an option to purchase real property is discussed in California Real Estate Law & Practice, Ch. 70, *Options to Purchase*, § 70.40[1] (Matthew Bender).

See generally California Real Estate Law & Practice, Ch. 70, *Options to Purchase Real Property*, § 70.02 (option agreement distinguishable from sales contract) (Matthew Bender).

California Forms of Pleading & Practice, Ch. 140, *Contracts*, § 140.23 (Matthew Bender).

1 Crompton et al., Matthew Bender Practice Guide: California Contract Litigation, § 13.37.

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46 of 79 DOCUMENTS

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Bernhardt and Hensley on Blickman Turkus

2008 Emerging Issues 2432

Professor Roger Bernhardt and William M. Hensley on *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC*, et al., 162 Cal. App. 4th 858, 76 Cal. Rptr. 3d 325, 2008 Cal. App. LEXIS 659 (April 30, 2008)

By Roger Bernhardt and William M. Hensley

June 30, 2008

SUMMARY: Get two expert commentaries on *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC*. Here, the court found that a realtor who represented the tenant in a complex commercial lease transaction did not have a duty to inform the landlord, after the lease was signed but before the tenant took possession, that the tenant's ability to perform the leases conditions was jeopardized by its deteriorating financial condition.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Bernhardt, Roger, and Hensley, William M. *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC, et al.* LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

Professor Roger Bernhardt on Blickman Turkus. Attorneys should be cautious in concluding too much from this decision. Its holding that a real estate broker is not liable for failing to tell the landlord of the impending financial collapse of a tenant is based on so many grounds, that whether any of them would be independently sufficient cannot be known.

The cross defendant broker was held not liable because:

1. It represented the tenant rather than the landlord;
2. It had received the information by way of confidential communications from the tenant;
3. The information came to it only after the lease between landlord and tenant had been executed; and
4. In any event, the landlord had entered into a very profitable lease termination arrangement with the tenant.

That combination of circumstances amounts to an overwhelming basis for rejecting a claim of tort liability against the broker, but does not show that any of the grounds individually would have worked.

That the broker was a cooperating broker, representing the tenant, rather than the listing broker representing the landlord, means that there was no fiduciary relationship to support a claimed duty to disclose. But even in the absence

of that, the broker for the other side has a general obligation of honesty and truthfulness, which could impose on it a duty to disclose material adverse facts known to it but not to the other party. Just as a seller's broker may have an obligation to disclose defects in the property to the buyer when it knows of them, so also may a tenant's or buyers broker be obligated to inform the other side of defects, i.e., weaknesses on the part of its own client, which could certainly include financial solvency. Thus non-agency, alone, is not a complete defense to nondisclosure.

That the broker received the information from confidential communications from its own client may also not, on its own, completely insulate it from a duty to disclose what it knows to the other side. Real estate brokers, especially when behaving as dual agents, may not be completely free from liability for intentionally not disclosing material information they possess from the other side. The attorney-client privilege does not apply to them, and if fraudulent inducement or fraudulent intent can be independently established, there may be liability. They may be forced to withdraw from the transaction rather than feeling compelled to lie.

That the information came about only after the lease had been executed is also likely to not constitute a perfect, independent defense standing alone. A duty to disclose probably readily survives signing of a sales contract and continues up to the close of escrow. When a lease is involved, disclosure duties can arguably continue beyond the leases signing until all preconditions are met, until possession has been turned over, or until rent has commenced, especially when complete payment of the brokerage commission has also been deferred. The duration of an agents disclosure duties is not at all certain.

Finally, the argument in the opinion that the landlord suffered no damages because it was already bound by the lease and could therefore not have searched for a substitute tenant in any event, would surely not be persuasive standing alone. Attorneys should still counsel brokers to advise their landlord clients of potential difficulties they may foresee with regard to current tenants, even when the existing lease arrangements are longer than month-to-month.

The landlords tort claims in this case were probably rejected mainly because of the very lucrative settlement that it had obtained in letting the tenant out. The various other reasons stated may have merely constituted some intellectual support for affirming the trial courts decision.

William M. Hensley on Blickman Turkus. n1 Although fairly lengthy from a page count standpoint, this Sixth District decision penned by Presiding Justice Rushing is required reading for practitioners with issues involving actions of an opponent's broker, the proper way to plead fraudulent concealment, and attorney's fees entitlement where there is no contractual predicate but the other side pleads entitlement to fees (an estoppel argument).

The main addition to broker jurisprudence is the conclusion that a broker representing a *commercial* opponent has no obligation to disclose to the opponent information about the deteriorating financial condition of his or her client occurring after a contract has been signed. Importantly, the Court of Appeal indicated the result might be different in *residential* transactions, but clearly did not mean a broker representing a *commercial* client had a duty to disclose certain adverse conditions. This decision appears correct, but was certainly so under the facts at issue--where the deteriorating financial events happened after the signing of the lease rather than during the contract negotiation stage.

With respect to pleading concealment, the appellate court showed some pragmatism sometimes missing even at early junctures of litigation. The Court of Appeal focused on counsel representations that they were dropping certain claims, only to renege and reallege them with even less certainty. This did not sit well with the appellate jurists, giving rise to a prudent dismissal under a sham pleading type of analysis.

The discussion on attorney's fee recovery is also enlightening. Neither party prevailed, such that there was little difficulty in sustaining the lower court's denial of fees to either side. However, the Sixth District did engage in a scholarly review of the law on the estoppel argument--whether a losing party which pleads claims for fees should get tagged with them by the other party even though there was no substantive contractual entitlement to fees in the first place. After reviewing all the decisions and casting doubt on the validity of certain prior published cases, the appellate

court declined to accept the estoppel theory, either as a matter of law or based on the particular facts under consideration. More discussion on the fee aspect of this decision can be found on a blog that Marc Alexander, a colleague, and I will be launching soon at www.calattorneysfees.com.

Cross References

For discussion of the facts, procedures, and holdings in *Blickman Turkus*, see the June 2008 issue of California Real Estate Reporter (Matthew Bender).

Levy et al., California Torts, Ch. 40, *Fraud and Deceit and Other Business Torts*, § 40.03 (False Representation of Existing or Past Material Fact) (Matthew Bender).

See generally California Real Estate Law & Practice, Ch. 63, *Duties and Liabilities of Brokers* (Matthew Bender)

[Return to Text](#)

n1 . This commentary originally appeared in the June 2008 issue of California Real Estate Reporter (Matthew Bender).

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47 of 79 DOCUMENTS

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Public Purpose Condemnation of Real Estate After Kelo

2008 Emerging Issues 66

Public Purpose Condemnation of Real Estate After Kelo

By Publisher's Editorial Staff 2008

June 4, 2008

SUMMARY: In a 2005 eminent domain case the United States Supreme Court approved a plan of economic development that primarily benefited a major pharmaceutical company while incidentally benefitting the public in the nature of increased community employment opportunities and increased tax revenues. The Supreme Court's decision in *Kelo v. City of New London*, 545 U.S. 469 (U.S. 2005) sparked a flurry of legislative responses. State lawmakers made it clear that "public use" was not elastic enough to include private economic development projects. This Emerging Issues Commentary examines the issue of taking private property for public use, the Supreme Court's decision, the definition of public use before Kelo and after the Kelo decision, the new legislation passed by the states, the different constitutional amendments passed after Kelo, and recent court responses to the Supreme Court's expansion of public use.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: Introduction

The Fifth Amendment to the United States Constitution provides that "No person shall be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." USCS Const. Amend. 5. At the time of the drafting of the USCS Const. Amend. 5, there were conflicting historical precedents regarding the meaning of the term "public use." England had no public use requirement. The colonies had used eminent domain power to condemn property for the purpose of mills. 13-79F *Powell on Real Property* § 79F.03. Certain individuals contended that there should be some limitation on the power of eminent domain and that it should be used only for the benefit of the public and not for the benefit of other private parties. The concept of "eminent domain" is "the government's authority to 'take private property for public use' so long as the owner receives 'just compensation' for the land taken." 11 *Alb. L. Envtl. Outlook* 41.

The issue of "public use" was not debated for the first four decades after the ratification of the United States Constitution because vast tracts of land were available in the public domain. Thus, it was not necessary to exercise the power of eminent domain for constructing public highways or even for constructing mill dams, private roads, or draining private property. In about 1830, when new uses of the eminent domain power departed from the traditional usages because of industrial expansion, the emergence of the railroads, and the provision of services by municipal

governments, landowners challenged the validity of the new uses. Thus, the courts were forced to face the issue whether a government taking had to be for a public use. 13-79F *Powell on Real Property* § 79F.03.

Early in the history of court decisions relative to eminent domain, the courts determined that "the sovereign may not take the property of A for the sole purpose of transferring it to another private party B, even if A is paid just compensation." However, the debate continued to wage over what constitutes a "public use." Court decisions on every level moved from a "narrow view" of the concept of "public use" to a "broad view" of "public use." The courts rendered great deference to the legislative determination of a "public use." In the state courts, a vast majority of questioned uses were found to be "public." The expanded "public use" has been approved for urban redevelopment, scenic easements, historic purposes, and reclamation of wetlands. In 2005, the United States Supreme Court rendered its decision in *Kelo v. City of New London*, 545 U.S. 469 (U.S. 2005) founded on the precedent of two prior United States Supreme Court cases and two cases from Michigan and California that expanded the concept of "public use" to permit the taking of property from a private individual for use by other private individuals if a legislative body deemed that the public obtained some benefit from the taking. Each of the five cases deferred to the wisdom of the legislative bodies to determine "public use." The response to the *Kelo* decision was prompt, extensive, and unprecedented in American history. This paper will examine *Kelo* and the legislative changes enacted in response to that decision.

Definition of "Public Use"

Two definitions of public use developed over time. The "narrow view" held that the taken property had to be for actual use by the public, i.e. government buildings, roads, parks, and other traditional public uses. Thus, under the "narrow view," property could only be acquired by eminent domain if the intent was for actual use by the public and not for the benefit of a private individual or a private company. The "broad view" of public use includes any use that contributes to the general welfare and prosperity of a community as a whole, even though a private individual might profit from the taking. Under the "broad view," nearly any use can be found to have a public advantage. The "broad view" clearly embraces the concept that the use of eminent domain for community development, or the addition of employment possibilities and the increase in tax revenue, constitutes a public use. The "broad view" extends great deference to the legislative authorities. In a series of cases, the United States Supreme Court and several state courts moved toward an adoption of an ever expanding "broad view" of public use.

Kelo v. City of New London

United States Supreme Court cases heard in 1954 and 1984 established the precedent for the Court's decision in *Kelo*. These cases expanded the definition of public use to include the taking of private property by eminent domain and the transfer of the taken property to other private individuals to obtain a legislative goal. *Berman v. Parker*, 348 U.S. 26 (U.S. 1954) approved a plan to eliminate "blight" in Washington, D.C. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (U.S. 1984) approved a plan to redistribute private property to achieve a broader base of private ownership of property. Two state court cases also expanded the concept of public use. In the Michigan case of *Poletown Neighborhood Council v. Detroit*, 410 Mich. 616 (Mich. 1981), the state court allowed private property to be taken to expand an automobile manufacturer's property for the public use of increased employment and increased tax revenues. A more extreme concept of public use was approved in the California case of *City of Oakland v. Oakland Raiders*, 32 Cal. 3d 60 (Cal. 1982), which permitted the taking of all of the property of a sports team franchise to prevent the team from leaving the City of Oakland, California, on the basis that the revenue realized from the presence of the sports franchise and the civic pride of a sports franchise was a legitimate public concern. None of the property taken involved real estate.

Against the backdrop of these cases, the United State Supreme Court's 2005 decision in *Kelo v. City of New London*, 545 U.S. 469 (U.S. 2005) sparked a flurry of legislative response to the Court's latest decision relative to the use of eminent domain. While allegedly adhering to the principle that the "property of a private individual should not be taken to benefit another private individual," the Court approved a plan of economic development that would primarily benefit

a major pharmaceutical company while incidentally benefitting the public in the nature of increased community employment opportunities and increased tax revenues.

Factual Background of Kelo

In January 1998, two years after the federal government closed a navel center in New London, Connecticut, the state authorized the use of eminent domain to facilitate an economic development project that included expansion of a state park, a conference center hotel, restaurants, shopping, marinas, new residences, a museum, office space, a riverwalk and the expansion of a pharmaceutical plant. The vast majority of the taken land would be used for the expansion of the pharmaceutical plant. Connecticut justified the use of eminent domain for the project as a public use on the basis that, although the project would significantly benefit private individuals and companies, it would confer "public benefits" of community renewal, employment opportunities, and increased tax revenue. Some landowners, whose residences were neither blighted nor in need of repairs, and whose homes were located in an area that was purchased for a yet-to-be defined use, refused to sell. The dissenting landowners filed condemnation actions in state courts. The landowners appealed the Connecticut Supreme Court's decision approving the community development plan and the condemnation actions. In *Kelo*, the United States Supreme Court affirmed the decision of the Connecticut Supreme Court.

Majority Opinion

The Supreme Court's majority opinion in *Kelo* noted that, although "the sovereign may not take the property of A for the sole purpose of transferring it to another private party B, even if A is paid just compensation," it is also clear that "a state may transfer property from one private party to another if future 'use by the public' is the purpose of the taking." The Court recognized that "promoting economic development is a traditional and long-accepted function of government," and concluded that economic development could not be distinguished from other public purposes previously recognized by the Court. The Court refused to require the government to demonstrate a "reasonable certainty" that the expected public benefits would accrue and declined to "second-guess the City's determination as to what constituted a public use."

Minority Opinion

The minority opinion sought to distinguish the New London situation from the use of eminent domain in *Berman* and *Midkiff* on the basis that in each of the previous cases, the extraordinary precondemnation use of the targeted properties "inflicted an affirmative harm on society and the relevant legislative body had found that eliminating the existing property use was necessary to remedy the harm." Justice Clarence Thomas, in an individual dissenting opinion, claimed that the Court had strayed from the "original meaning" of the Public Use Clause of USCS Const. Amend. 5.

Response of States to Kelo

"Public reaction against the majority opinion in *Kelo* was swift, intense, and unprecedented. State lawmakers in every region of the nation took up the cause of making clear that 'public use' was not elastic enough to include private economic development projects." 13-79F *Powell on Real Property* § 79F.03. By the end of 2006, 39 states enacted eminent domain reform legislation. Delaware was the first state to amend its statutes to require additional procedures of eminent domain. In addition to Delaware, the states of Alabama, Alaska, California, Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Carolina, Ohio, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Vermont, West Virginia and Wisconsin enacted legislation to limit the use of eminent domain that would benefit private individuals or companies. During the 2006 fall elections, voters in the nine states of Arizona, Florida, Georgia, Louisiana, Michigan, New Hampshire, North Dakota, Oregon and South Carolina passed ballot measures that changed their state constitutions to limit the use of eminent domain. The states of Maryland, Montana, New Mexico, Nevada, Virginia, Washington, and Wyoming followed that trend in 2007.

Public Use Defined

Most of the state responses, whether by statute or voter referendums, narrowed the definition of public use. A majority of the states defined public use by designating those uses where the use of eminent domain was prohibited. The vast majority of the statutory amendments prohibit the use of eminent domain for economic development in non-blighted areas and where the public use is incidental to the scope of the project. Most State statutes were amended to provide that public use does not include employment opportunities or increased tax revenue or private roads.

Permissive Uses of Eminent Domain

"Blighted" Properties

Along with the designation of prohibited "public uses" of eminent domain, most state statutes specifically designated those uses that are not prohibited. One of the more frequently described permissive public uses of eminent domain is to eliminate "blighted" areas within a community. Most of the statutes specifically define "blight" and protect unblighted properties even in a blighted area. Missouri's new statute requires the condemning authority to "individually consider each parcel of property in the defined area with regard to whether the property meets the relevant statutory definition of blight." 2006 Mo. HB 1944. Takings can only be commenced if, after such individual determinations, it is found that a preponderance of the defined redevelopment area is blighted. Other provisions of the Missouri statute prohibit the use of eminent domain to take farmland as "blighted property." Iowa permits takings due to "blight" only if 75 percent or more of the area included in the plan consists of property in a slum or blighted condition. 2006 Ia. ALS 1001. North Carolina also requires that blight determinations be made on a parcel by parcel basis. North Carolina defines "blight" as "dilapidation, deterioration, age or obsolescence, inadequate provision for ventilation, light, air, sanitation, or open spaces, high density of population and overcrowding, and unsanitary or unsafe conditions." 2005 Bill Text NC H.B. 1965.

Public Utilities

Most state statutes specifically provide that the new legislation does not affect takings for public utilities that provide gas, electric, or water to the community's citizens. Other permissive takings include transportation projects, water supply and drainage projects, and waste disposal projects. Generally, government buildings, roadways, and park and recreational facilities are permitted "public uses." For a detailed analysis of the provisions of the state statutory changes, see 13-79F *Powell on Real Property* § 79F.03.

Legislative Changes

State legislators reacted almost immediately to *Kelo* by adopting legislation that prohibit the taking of private property by eminent domain for development purposes that benefit private individuals or businesses, especially where the anticipated public benefit merely increases employment possibilities and increases tax revenues. However, most state legislatures exempted the taking of "blighted" areas for development purposes or takings for public utilities, transportation services, and public roads and highways from the prohibition. The state legislative changes not only more clearly defined "public use," but included additional safeguards and procedures for the use of eminent domain as well as requiring additional payments over and above fair market value when property was taken pursuant to eminent domain

Delaware

Delaware was the first state to change its eminent domain statutes. Delaware amended 29 Del. C. § 9505 by imposing additional pre-taking procedures to provide that "the acquisition of real property through the exercise of eminent domain shall be taken, and the property used, only for the purposes of a recognized public use as described as least six months in advance of the condemnation proceedings: (i) in a certified planning document, (ii) at a public hearing held specifically to address the acquisition, or (iii) in a published report of the acquiring agency."

Alabama

Alabama directly referenced *Kelo* in its corrective legislation and designated that, despite the *Kelo* decision, "no governmental bodies in Alabama vested with all or any part of the power of public domain may use the power to take the private property of any person for the private use of another." Code of Ala. § 11-47-170. Alabama does make an exception where there has been a finding of blight in an area covered by a redevelopment plan or urban renewal plan.

Texas

Texas lawmakers attempted to define inappropriate uses of eminent domain by prohibiting its use to "confer a private benefit on a particular private party through the use of the property" or "for a public use that is merely a pretext to confer a private benefit on a particular party" or primarily for economic development purposes. Tex. Gov't Code § 2206.001. However, the Texas legislature made it clear that the new provision did not apply to transportation projects, water supply and drainage projects, utility service provisions and waste disposal projects.

Ohio

Ohio lawmakers established a moratorium until December 31, 2006, on the use of eminent domain to "take, without the consent of the owner, private property that is not within a blighted area when the primary purpose for the taking is economic development that will ultimately result in ownership of that property being vested in another private person." 2005 Ohio SB 167. The Ohio legislature exempted takings for public utilities, common carriers, public parks, recreation areas, and government buildings and grounds from the moratorium. ORC Ann. 1.08, revised pursuant to 2007 Ohio SB 7, specifically defines a blighted areas and slums as an area in which at least seventy per cent of the parcels are blighted and requires proposed redevelopment plans that seek appropriation to submit a statement that shows the basis for a finding of blight.

South Dakota

The South Dakota legislation prohibits eminent domain use by a locality or housing and redevelopment commission "for transfer to any private person, nongovernmental entity, or other public private business entity" or "primarily for enhancement of tax revenues." 2006 S.D. ALS 66. In addition, South Dakota's statutory changes included counties, municipalities, or housing and redevelopment commissions from transferring any property acquired by the use of eminent domain within seven years of acquisition to any private person or non-governmental entity without first offering to sell the property back to the original owner of the property at the lesser price of the current fair market value of the original transfer value.

Indiana

Indiana lawmakers placed a two-year limit on condemnation if a landowner refused a "written acquisition offer." The time period for the state department of transportation is three years and the period of public utilities is six years. Indiana lawmakers specified that "public use does not include the public benefit of economic development, including an increase in a tax base, tax revenues, employment, or general economic health." 2006 Ind. ALS 163. The Indiana legislation permits the condemnation of private property from one private person to another private person if the taken property constitutes a public nuisance or fire hazard, is unfit for human habitation, is neglected or abandoned, is environmentally contaminated, or has tax delinquencies. The new legislation provides for compensation above fair market value for agricultural landowners and for residential properties as well as relocation costs.

Kentucky

Kentucky's eminent domain revisions are more moderate and typical of the approach taken by many legislatures. The Kentucky bill defines public uses as the "possession, occupation, or enjoyment of the property as a matter of right by the Commonwealth, a political subdivision thereof, or other governmental entity or the acquisition and transfer of property for the purpose of eliminating blighted areas, slum areas, or substandard and unsanitary areas." 2006 Ky. Acts 73. The statute bans takings solely for economic development or to increase the tax base or tax revenues, to increase employment, or to promote the general economic health of the community. The prohibition does not prohibit the sale or lease of property to private entities for incidental use of a public project or building.

Wisconsin

Wisconsin's legislation prohibits the taking of property that is not blighted if the condemnor intends to convey or lease the acquired property to a private entity. Wisconsin's legislature defines "blighted property" as property that has been abandoned, converted from a single family dwelling into multiple dwelling units, and in a area where the crime rate in, on, or adjacent to the property is higher than that in the remainder of the community where the property is located. 2005 Wis. ALS 233.

Florida

The action taken by Florida legislators is likely to create a great deal of controversy in that 2006 Fl. ALS 11 prohibits the use of eminent domain to "take private property for the purpose of preventing or eliminating slum or blight conditions," but also forbids takings "for the purpose of abating or eliminating a public nuisance." However, the statute permits counties and municipalities to adopt or enforce ordinances and eliminate public nuisances to the extent that such "ordinances do not authorize the taking of private property by eminent domain." The Florida legislation permits a condemning authority to transfer property taken by eminent domain if less than 10 years have elapsed since the taking and the property is no longer needed for its original purpose as long as the original owner of the property has been given the opportunity to repurchase the property at the price paid by the condemning authority to the original owner.

Alaska

Alaska's legislators prohibit the power of eminent domain "to be exercised for the purpose of developing a recreational facility or project if the property to be acquired includes an individual landowner's personal residence or that portion of an individual's property attached to and within 250 linear feet of an individual landowner's personal residence unless the landowner consents." 2006 AK. ALS 84.

State Constitutional Amendments

Louisiana was the first of several states to amend state constitutional takings provisions in September 2006. The new provision limits the definition of "public purpose" and specifies that "neither economic development, enhancement of tax revenue, nor any incidental benefit to the public shall be considered in determining whether the taking or damaging of property is for a public purpose." La. Const. Art. I, § 4B(3). Voters in Florida, Georgia, Michigan, New Hampshire, and South Carolina also made constitutional changes in November 2006 that were placed on the ballot by state legislators. In the same election, Arizona, California, Idaho, North Dakota, Oregon, Nevada, and Washington considered ballot measures on the issue of eminent domain that originated in citizen petitions. The initiatives were successful in Arizona, Nevada, North Dakota and Oregon. The Arizona initiative narrowed the definition of "public use," and included a "regulatory takings" provision that puts at risk land-use regulations that reduce property values. The regulatory takings language was not included in the successful North Dakota and Oregon initiatives. California, Idaho and Washington struck down ballot measures that incorporated regulatory takings language.

Other Changes in State Statutes

In addition to changes in "public use" definitions and prohibitions against public use for economic development,

employment, and increased tax revenues, legislators included additional provisions relating to eminent domain procedures. One of the more frequent inclusions was the requirement of payment for takings in excess of fair market value. Many statutory changes also provided for payment for relocation costs and attorney's fees as well as payments for loss of business income. Additional provisions stipulated a right of first refusal by the landowner whose land was taken to reacquire the property if the property was not used for the public purpose before the taken property could be transferred to another private owner. Other provisions expand notice and hearing requirements and disqualify interested persons from voting on matters affecting organizations that may be involved in eminent domain proposals.

Recent Court Responses to the Expansion of "Public Use"

Although the "broad view" generally prevails in state and lower federal courts, several recent state court cases have distinguished *Kelo* and the cases leading up to *Kelo* to limit the taking of private property for economic development and to check the expanding view of "public use." Although the Supreme Court precedents of *Berman*, *Midkiff*, and *Kelo* have made it highly unlikely that a court would find a use not to be "public," some courts have bucked the prevailing trend.

In 2004, 23 years after its controversial decision in *Poletown*, the Michigan Supreme Court overruled its expansive view of public use in a successful challenge to a county's attempted condemnation of private lands for the construction of a state-of-the-art business and technology park in *County of Wayne v. Hathcock*, 471 Mich. 445 (Mich. 2004). Further, the court made its ruling retroactive and applicable to all pending cases in which the parties had preserved a challenge to the *Poletown* formulation of "public use." In a 2001 retail store's challenge to the use of eminent domain for the expansion of an existing major retail store, the court did not find a public use for the taking. *99 Cents Only Stores v. Lancaster Redevelopment Agency*, 237 F. Supp. 2d 1123 (D. Cal. 2001). Similarly, in a 2002 decision, the Supreme Court of Illinois refused to allow a regional development authority to use its eminent domain power to take property away from two private landowners to be used as parking for an adjacent racetrack. *Southwestern Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C.*, 199 Ill. 2d 225 (Ill. 2002).

The Supreme Court of Ohio, in a unanimous opinion, cited Justice Sandra Day O'Connor's *Kelo* dissent favorably in a 2006 Ohio case in which the court invalidated the city of Norwood's use of eminent domain to take homes for a new shopping center. *City of Norwood v. Horney*, 110 Ohio St. 3d 353 (Ohio 2006). In moving away from the *Kelo* majority's deference to government officials, the Ohio Supreme Court opinion emphasized the fundamental importance of private property rights. While Ohio law allows the use of eminent domain for slum or blighted property, the court saw a determinative difference when Norwood officials aided a private redevelopment project by using the municipality's power to take the houses of a few hold-outs who refused to sell their properties to the developer.

Federal Statutory Responses to *Kelo*

In addition to the responses by states to *Kelo*, Washington, D. C. officials have expressed dissatisfaction with the *Kelo* holding, and reform bills have been filed in Congress. However, only one provision has become law in an appropriations bill that prohibits the use of funds to support the use of eminent domain for economic development that primarily benefits private entities. 109 P.L. 115, sec. 726. In addition, President Bush issued an executive order to protect the property rights of the American people that requires the United States Attorney General to monitor takings by departments and agencies. 71 FR 36973.

Conclusion

State legislators responded to the Supreme Court's reiteration that legislation should determine the definition of "public use" rather than the courts to make sweeping changes in the definition of "public use." Recognizing the slippery slope of an expanding definition of "public use," most state legislators limited the use of eminent domain to actual public uses. Most state legislators have rejected the concept that economic development that greatly benefits a private individual or company to the detriment of another private individual or company is a justifiable "public use." The response of state

legislators has severely limited the use of *Kelo* as a precedent in future "public use" determinations of valid uses of eminent domain. The Ohio Supreme Court's decision in *City of Norwood v. Horney*, 110 Ohio St. 3d 353 (Ohio 2006) offered a helpful hint to other state courts in a statement that that the decision was limited to those points of law that required an immediate decision in light of the legislature's current review of eminent domain legislation.

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48 of 79 DOCUMENTS

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Bernhardt and Hensley on Michel, 2007 Cal. App. LEXIS 1800 (2007)

2008 Emerging Issues 2310

Professor Roger Bernhardt and William M. Hensley on Michel v. Palos Verdes Network Group, Inc., 156 Cal. App. 4th 756, 67 Cal. Rptr. 3d 797, 2007 Cal. App. LEXIS 1800 (2007)

By Roger Bernhardt and William M. Hensley

May 13, 2008

SUMMARY: Review two Emerging Issues Analysis covering the practical implications of Michel v. Palos Verdes Network Group, Inc. The second of these two commentaries originally appeared in the December 2007 issue of California Real Estate Reporter (Matthew Bender).

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Commentary by Professor Roger Bernhardt. In most situations involving residential home purchases, negligent nondisclosure liability will overlap with liability for failure to provide a complete transfer disclosure statement (TDS) based on California Civil Code § 1102.13. It is only in an unusual situation, such as occurred here, that there is one liability notwithstanding absence of the other.

When a sellers agent fails to disclose defects to the buyers, it is probably inevitable that the TDS will contain the same omission. Therefore, there will be no need for a court to determine if there is negligent nondisclosure liability over and above the statutory liability for damages for a deficient TDS.

Similarly, when the nondisclosure is by the buyers own agent, the omission is also almost certain to appear in their part of the TDS form, imposing on them the same statutory liability as is imposed on the sellers agent.

In *Michel*, because the real estate agent who possessed the undisclosed critical information was functioning as transaction coordinator rather than as direct agent for either party, he had no transfer disclosure statement responsibility. However since he was employed by the selling broker and he clearly did participate in the deal, he incurred fiduciary responsibilities even if he had no TDS obligations. His nonperformance of these fiduciary duties thus exposed his employer to negligent nondisclosure liability.

Commentary by William M. Hensley. n1 This decision exemplifies how proper demarcation of a suing claim frequently keeps a plaintiff in the litigation ballgame.

Justice Rubin, writing for the Second District, correctly noted that the plaintiff-buyer did have a viable constructive fraud theory against his own broker/salespersons. Although inartfully postured as ""negligent nondisclosure,"" the

proper gist of plaintiff's case was breach of fiduciary duty and failure to disclose material defects from an inspection to the buyer of residential property.

This case is somewhat strange because the trial court incorrectly allowed the parties to submit a statutory claim under *Civil Code section 2079* to the jury. The appellate court noted, in footnote 5 of the opinion, that section 2079 only imposes duties upon a selling broker, not the buyer's own broker. This teaches that the parties need to be very careful to read the germane statutes and make sure that they are submitting a proper claim to the jury. Nonetheless, the submission of a wrong theory did not hurt the plaintiff in this case because constructive fraud entails broader duties than those submitted under a simple negligence theory.

There are also pragmatic implications that stem from this decision. Much like law firms which need to have some conflict screening mechanisms, brokerage houses are well advised--after this decision-- to devise a ""tracking system"" by which salespersons can determine whether other agents made prior or subsequent inspections with a prospective buyer for purposes of fulfilling their fiduciary duties. Only in this way can brokerage or salespersons representing buyers escape the potential liability that can follow from submission of a fiduciary duty breach theory to the jury based on failure of different salespersons to share their inspection results with prospective buyers. From the facts I gleaned from this decision, it appears likely that a jury might well return with a verdict against the broker/salespersons upon an adjudicated trial on remand.

Cross References

. California Real Estate Law and Practice, Ch. 63, *Duties and Liabilities of Brokers*, § 63.10 et seq. (Matthew Bender).

. California Real Estate Law and Practice, Ch. 71, *Real Property Purchase and Sale Agreements*, § 71.30 Statutory Real Estate Transfer Disclosure Statement and Related Requirements (Matthew Bender).

. California Forms of Pleading and Practice, Ch. 103, *Brokers*, § 103.31 (Matthew Bender).

. **For full treatment of the procedures, facts, and holdings of this case**, see the December 2007 issue of California Real Estate Reporter (Matthew Bender).

Return to Text

n1 1 This commentary originally appeared in the December 2007 issue of California Real Estate Reporter (Matthew Bender).

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49 of 79 DOCUMENTS

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Professor Roger Bernhardt on McClain v. Octagon Plaza, 2008 Cal. App. LEXIS 157

2008 Emerging Issues 2311

Professor Roger Bernhardt on McClain v. Octagon Plaza, LLC, 159 Cal. App. 4th 784, 71 Cal. Rptr. 3d 885, 2008 Cal. App. LEXIS 157 (2d Dist., Jan. 31, 2008)

By Roger Bernhardt

May 13, 2008

SUMMARY: This Emerging Issues Analysis analyzes *McClain v. Octagon Plaza, LLC, 2008 Cal. App. LEXIS 157*, a case in which the court found that a commercial tenant stated a cause of action against her landlord for negligent or intentional misrepresentation based on the landlords alleged exaggeration of the size of rental unit by 186 square feet. The discrepancy between the size as represented and the actual size was not de minimis.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: There is nothing remarkable in the part of this decision that holds that the number of square feet stated in a commercial lease and the formula for allocating common area charges based on square footage is not insulated from the charge that it was an intentional misrepresentation because the lease also included a provision that the number was only an approximation that both parties deemed reasonable. When a misstatement was intentional, an exculpatory clause will not protect it, and the approximation language of the lease in *McClain* would be no more effective than an as is clause in a contract of sale for a property. But fraud is always easier to allege than to prove. A complaining tenant must show not only that there was a discrepancy between the square footage stated in the lease and the one stated in the landlords insurance application, he/she must also show that (1) the landlords knew the lease number was wrong, and (2) the landlords intended to deceive the tenant about it. (In this case, inferring of such intent may turn on whether it was the landlords or the other tenants who reaped the benefit of this tenants overpayment of common area charges. The opinion does not mention whether the other shopping center tenants paid accordingly smaller shares of the common area charges or whether the landlords were pocketing the excess themselves.)

More importantly, the court in *McClain*, by also overturning the demurrer to the cause of action for negligent misrepresentation as to the size of the premises, has made life much harder for this landlord in this litigation as well as more complicated for all other parties involved in transactions that require measurements. If a measurement stated in the documents is incorrect, and any negligence can be shown on the part of the measurer (such as a different number appearing in a different document prepared by the same measuring party), then no matter how small the discrepancy is (8 percent in this case) liability for negligent misrepresentation may not be avoided by a disclaimer in the documents that no one was completely certain as to what the precise number actually was. The ability of the parties to both make a guess and state it as a precise number at the same time has become considerably more uncertain. When that number later turns out to be incorrect, litigation becomes much more likely.

Cross References

. 2 Crompton et al., Matthew Bender Practice Guide: California Contract Litigation, Ch. 18, *Asserting or Defending Claim That Contract Is Illegal, Contrary to Public Policy, or Unconscionable*, 18.06.

. California Forms of Pleading and Practice, Ch. 140, *Contracts*, § 140.24 (Matthew Bender).

. **For full treatment of the procedures, facts, and holdings of this case**, see the March 2008 issue of California Real Estate Reporter (Matthew Bender).

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50 of 79 DOCUMENTS

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Bernhardt on Bruni v. Didion, 2008 Cal. App. LEXIS 357

2008 Emerging Issues 2226

Professor Roger Bernhardt on Bruni v. Didion (4th Dist., March 12, 2008) 160 Cal. App. 4th 1272, 2008 Cal. App. LEXIS 357

By Roger Bernhardt

April 28, 2008

SUMMARY: *Professor Roger Bernhardt's Emerging Issues Analysis on Bruni v. Didion 160 Cal. App. 4th 1272, 2008 Cal. App. LEXIS 357 (4th Dist., March 12, 2008), where a California appellate court found that a home builders contract requiring the arbitration of disputes was unconscionable because the arbitration provisions were contained in a contract of adhesion and violated the buyers' reasonable expectations.*

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: This opinion contains so many reasons for invalidating the particular arbitration provision involved in the case that it becomes effectively useless to counsel in any other matter attempting to cite or rely on the decision either for litigation or drafting purposes.

The courts conclusion that surprise was established was based on a recitation of an enormous number of factors:

- . That the provision took up only one page of a 30 page booklet;
- . That it was single spaced and in 10 point type;
- . That there was no boldface or capitalized print in it;
- . That the booklet containing the provision had been neither signed nor initialed, nor had the arbitration provision itself been signed or initialed;
- . That the one form the purchasers had signed that referred to the provision provided no information as to it; and, finally;
- . That its effect was misrepresented by the brokers.

This enumeration certainly shows what was wrong in this particular situation, but does not give advice helpful to other situations. Whether the arbitration provision involved in this case--or any other one--could have been made valid by the elimination of one or more, but less than all of the cited defects, is unknown.

Attorneys determining whether to bring suit without complying with the arbitration clause in their own clients contracts come away with only mixed guidance from this decision: the more of the same defects that appear in their own documents, the more it is likely that they can litigate instead of having to arbitrate. However, the reverse is no less true, and the opinion says very little as to the relative importance of all of the defects that it mentions.

The same uncertainty is also true for attorneys asked to analyze or improve the language of their clients existing form arbitration provisions. They too still need to guess as to what counts and what does not.

Cross References

. California Forms of Pleading and Practice, Ch. 32, *Contractual Arbitration: Agreements and Compelling Arbitration*, § 32.21 (Matthew Bender)

. **For a discussion of the facts, procedures, and holdings in *Bruni***, see the April 2008 issue of California Real Estate Reporter (Matthew Bender).

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51 of 79 DOCUMENTS

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Bernhardt on Neighbors

2008 Emerging Issues 2154

Professor Roger Bernhardt on Neighbors in Support of Appropriate Land Use v. County of Tuolumne

By Roger Bernhardt

April 17, 2008

SUMMARY: Get Professor Roger Bernhardt's expert insight on the California appellate court decision in *Neighbors in Support of Appropriate Land use v. County of Tuolumne*, where the court found that the county's adoption of a development agreement purporting to allow property owners to operate a commercial enterprise on property zoned for exclusive agricultural use violated the zoning uniformity requirements of the California Government Code.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Bernhardt, Roger. *Neighbors in Support of Appropriate Land Use v. County of Tuolumne*. LexisNexis Expert Commentary, (Insert date you accessed the document online).

Practitioners representing developers who need relief from the existing land-use regime should take this decision seriously even though almost all of the arguments given by the court are technically quite dubious. The basic holding of the case -- that a county may not permit by development agreement what is not authorized under its zoning ordinance -- is one that most courts would also endorse in any event and one that the California Legislature is unlikely to revise, even though its current statutes do appear to be contrary.

The California Development Agreement statute [Cal. Gov. Code § 65866] seems clearly to authorize development agreements to permit uses not otherwise permitted under local zoning ordinances. Furthermore, the requirement of consistency in Cal. Gov. Code § 65867.5 between a development agreement and all applicable general and specific plans also appears to eliminate any need for consistency between the agreement and the zoning ordinance. And, finally, the provision in Cal. Gov. Code § 65865.2 that the agreement specify the permitted uses of the property seems to offer a third reason for believing that the Legislature intended to give local governments power to use development agreements as a mechanism for regulating land use that functions as an alternative to their traditional zoning power. The courts attempt to distinguish away these three statutory provisions -- plus its almost cavalier dismissal of the principle that these more specific statutes should take precedence over a more general one (in this case, the uniformity principle of Cal. Gov. Code § 65852) -- are unlikely to be found technically persuasive, but it is probably even more unlikely that the Legislature would feel motivated to reassert its power when the result reached by the court was probably harmless as well as desirable.

The result was probably harmless because land-use practitioners do not, in fact, expect development agreements to

accomplish for their clients the results that a rezoning or zoning amendment, or conditional use permit are designed to achieve. As part of getting land development projects started in the first place, developers seek to obtain all of the necessary entitlements through conventional land-use regulations and expect any development agreements that are also negotiated to serve to freeze the entitlements so that they may not be taken away later. The purpose of a development has always been to create a vested right rather than a more flexible zoning tool.

As was true in this case itself, the applicants could have readily achieved all of their goals by way of zoning amendment rather than development agreement, and done so by following what appeared to be the same local procedures which were applicable to either situation. (Indeed that has probably now been done.) It is unlikely that there would have been any measurable increase in start-up costs had those ordinary procedures been followed. Thus, since developers do not need development agreements to give them any additional flexibility of development, they are unlikely to lobby the Legislature for it to reverse this decision with new statutory language. Development agreements will continue to give developers the assurance they deem necessary to undertake projects that have independently acquired the necessary entitlements and their utility will not be diminished because they cannot otherwise substitute for rezonings or conditional use permits. The Institute for Local Self-Government, whose Development Agreement Manual opining to the contrary was relied on by the County, will now have to revise that publication, but it seems unlikely that there will be any real opposition -- political or financial -- to doing so.

Cross References

. Manaster & Selmi, California Environmental Law & Land Use Practice, Ch. 60, *Zoning*, § 60.70 (Matthew Bender)

. California Real Estate Law & Practice, Ch. 260, *Sources and Limitations of Zoning Power*, § 260.37 (Matthew Bender)

. California Real Estate Law & Practice, Ch. 261, *Types of Zoning Controls*, § 261.69 (Matthew Bender)

. **For a thorough discussion of the facts, procedures, and holdings in this case**, see the January 2008 issue of the California Real Estate Reporter, p. 4 (Matthew Bender)

ABOUT THE AUTHOR(S):

Roger Bernhardt, Professor of Law at Golden Gate University in San Francisco, is author of Bernhardt's California Real Estate Codes (LexisNexis), California Mortgage and Deed of Trust Practice (CEB), as well as numerous books on Property and Mortgage Law for students. He is also Editor of CEB's California Real Property Law Reporter and Bernhardt's Mortgage Law Newsletter. (RBernhardt@GGU.edu)

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52 of 79 DOCUMENTS

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Accepting the Post-Acceleration Check: A Respectful Explanation

2008 Emerging Issues 220

Accepting the Post-Acceleration Check: A Respectful Explanation

By Bruce J. Bergman

March 27, 2008

SUMMARY: A leading misconception in the arena of mortgage servicing and foreclosure is that any mortgage payment remitted after acceleration must be returned and rejected. The real rule is that a post-acceleration check not sufficient to reinstate the mortgage can be accepted. Whether a mortgagee wishes to do so, however, becomes more of a business, rather than a legal, decision.

PDF LINK: Enhanced Emerging Issues Commentary (\$)

ARTICLE: A leading misconception in the arena of mortgage servicing and foreclosure is that any mortgage payment remitted after acceleration must be returned and rejected. The real rule is that a post-acceleration check not sufficient to reinstate the mortgage *can* be accepted. Whether a mortgagee (sometimes lender, mortgage holder, or mortgage servicer) *wishes* to do so, however, becomes more of a business, rather than a legal, decision which will be explained below.

Before Default and Acceleration

Thinking about what mortgage servicers do with late remittances before default becomes an issue should help in better understanding how to handle payments once there is a default.

Using low numbers in a residential situation just for ease of reference, suppose the borrowers monthly mortgage payment is \$1,000, due on the first of the month (lets say its January) with a typical 15-day grace period. (The payment could just as well be \$10,000 or \$100,000 per month.) The check isnt drawn until the 18th and not received by the servicer until the 21st. Would the servicer send the check back? Of course not. Unless the servicer is anxious to foreclose, this is just a late payment (hardly so unusual) and maintaining a performing loan is typically the goal.

Assume next that no payment ever arrives during January, but \$1,000 is submitted on February 17, by which time both January and February are late and \$2,000 is due. Would the servicer send back the \$1,000? Again the answer is no. The \$1,000 is applied to January; February remains open and calls or letters will likely be addressed to the borrower to correct the situation.

At this moment, the borrower is in default, but no default has been declared or effectuated. Nothing official has happened. There is nothing a servicer can waive. We just have a slow paying borrower -- no legal issues, no legal confusion.

Role of the Breach Letter

Because the Fannie/Freddie uniform instrument imposes it, for residential mortgages, most often a prerequisite to accelerating the mortgage balance is the sending of a breach notice to the borrower advising of the nature of the default and affording 30 days to cure. This commonplace requirement tends to muddy our underlying question and so addressing it first will serve to clarify.

Assume our same borrower, but this time, nothing has been received for January, February, and March. On March 19 (with the grace period now passed for that month also) the mortgage servicer sends the breach letter requiring submission within 30 days of \$3,060 (three months of past due installments and three months of late charges).

What if the borrower sends \$2,000 on the 27th day? Can the check be accepted, or must it be returned? The real question to ask is whether upon submission of the \$2,000 the borrower's default has been cured. The answer, of course, is no, because the remittance failed to include one monthly sum and the late charges. Therefore, as of the moment of submission -- and at conclusion of the 30-day cure period -- the borrower remains in default.

If one thinks about it, the circumstance is really the same as that usual, earlier situation where no default was declared and in February the mortgage servicer correctly applied the check to January. To emphasize the point, the borrower remains in default even when the \$2,000 is accepted and retained. Accordingly, at the conclusion of the 30 days, the mortgage servicer is free to declare due the balance of the mortgage (accelerate) even though some money has been received. (And there is no need, by the way, to rebreach.)

This then leads us to the heart of the matter: monies submitted after that acceleration.

Post-Acceleration Payments

For ease of analysis, let's assume that the borrower in default for January through March ignored the breach letter entirely so that acceleration occurred in early April, at which time the arrears were \$4,060. (This is four months worth of installments and late charges. In a commercial case the late charges would be higher and in any particular matter there could be other sums due. But the underlying principles remain constant.)

As a matter of law in New York, and many jurisdictions, once a mortgage has been accelerated, a mortgage holder need not accept a reinstatement. The lender has become entitled to the full balance of the mortgage. The only exception to the rule is that the parties can make a different agreement in their contract (which is the mortgage). The Fannie/Freddie version does indeed oblige the mortgage holder to accept a reinstatement up to the moment a foreclosure judgment issues (in judicial states like New York) with the further condition that *all* arrears are submitted, including legal fees. Any mortgage could theoretically contain such a provision although it is hardly standard beyond the Fannie/Freddie versions.

There is thus a rule here: with the common Fannie/Freddie mortgage, there can be reinstatement after acceleration, and if the check is in the correct reinstatement amount the lender or servicer must accept it. It cannot be rejected. But this has nothing to do with waiver of acceleration. It is the rule because it is what the parties agreed to.

Now we arrive at the ultimate point and the pervasive myth. Suppose after acceleration the borrower remits *less* than all the arrears. Does it have to be returned? No. (Remember, the Fannie/Freddie mortgage is silent on this point.)

When the borrower submitted less than full arrears, was the borrower not still in default? Yes. The fear that gives rise to the myth is that accepting a payment after acceleration is a waiver of that acceleration -- a wise concern. Here's

the rule. Assuming no Fannie/Freddie mortgage form (so that full reimbursement need not be accepted), receipt and retention of a sum sufficient to reinstate is a waiver of acceleration. Because the lender does not have to take it, if it does not want it, then it can be promptly returned. Thus no waiver can eventuate.

When the remittance would not be enough to reinstate, then the acceleration cannot be waived by accepting it, so retaining the check presents no legal impediment.

That said, there remain practical concerns. A borrower bent on delaying or defeating the foreclosure could claim that the reason he or she submitted a part of the payment after acceleration was because he or she had entered into a verbal understanding with the servicer who agreed not to foreclose if that amount was sent. It is most often not true, but a sympathetic court might give the assertion credence under some circumstances, particularly where there is no clear written record to disprove the agreement. One way to avoid the problem is to send a letter to such borrowers advising that receipt of the check is insufficient to reinstate, its acceptance is not a waiver and is without prejudice to exercise all of the lenders rights and without prejudice to continuation of the foreclosure.

From an overall perspective there are two practical views of all this. Some lenders or mortgage servicers welcome receipt of large sums of money. (Across a broad portfolio the dollars add up.) They would prefer to receive these amounts and if in one of 100 cases a borrower wins a waiver claim, it is a minor price to pay. Other lenders or servicers prefer to avoid any litigation whenever possible and so reject all sums which would not reinstate the mortgage.

It therefore becomes a matter of business judgment: take all the money and lose a case in a rare instance (to later begin anew), or avoid the concern altogether by rejecting all the post-acceleration checks. But it remains a myth that a check after acceleration cannot be retained. As a matter of *law*, it can be. As a matter of *business*, the mortgage holder must decide.

For further discussions on default and acceleration, see Bergman on New York Mortgage Foreclosures, Ch. 4, (LexisNexis Matthew Bender).

For more discussions on mortgage foreclosures, see Bergman on New York Mortgage Foreclosures (LexisNexis Matthew Bender); Powell on Real Property ch. 37, *Mortgages and Mortgage Foreclosures* (Michael Allan Wolf ed., LexisNexis Matthew Bender). Warrens Weed N.Y. Real Property, Chapter 96, Mortgage Foreclosure Part 23, *Exploring Rights of Owner of Equity Of Redemption* (LexisNexis Matthew Bender) ; Real Estate Financing § 10.10, *Foreclosure* (LexisNexis Matthew Bender).

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53 of 79 DOCUMENTS

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Shaffer on Environmental Defense Project of Sierra County v. County of Sierra

2008 Emerging Issues 1995

Shaffer on Environmental Defense Project of Sierra County v. County of Sierra

By Edward L. Shaffer

March 5, 2008

SUMMARY: Review expert commentary on *Environmental Defense Project of Sierra County v. County of Sierra*, 2008 Cal. App. LEXIS 20 (January 9, 2008), where the court found that a streamlined zoning process, under which the county gave notice of a hearing before the board of supervisors prior to the planning commission making its recommendation on a proposed or amended zoning ordinance, violated the California Planning and Zoning Law. The commentary also appears in the March 2008 issue of CALIFORNIA ENVIRONMENTAL LAW REPORTER (Matthew Bender).

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Beware Trying to Fast-track Hearings. Developers pushing to complete the approval process often want to speed up the final hearing--especially after suffering prolonged CEQA review. One tactic sometimes used is to schedule the city council or board of supervisors approval hearing right after the planning commission completes its review. However, a recent appellate court decision warns that this attempt to save time may backfire. (References to board in this commentary also include city councils.)

In brief, the California Court of Appeal in *Environmental Defense Project of Sierra County v. County of Sierra*, 158 Cal. App. 4th 877, 70 Cal. Rptr. 3d 474, 2008 Cal. App. LEXIS 20 (Cal. Ct. App. 2008), has ruled that when the planning commission is required to hold a hearing and make a recommendation first, the board hearing notice cannot be published until the commission (1) has completed its hearing, (2) adopted its recommendation, and (3) formally delivered the recommendation. Furthermore, the board hearing notice must include the commissions recommendation. The court found these requirements necessary to properly inform the public of exactly what the board was about to consider, and provide adequate opportunity to prepare and comment on the recommended approval.

Sierra County requires applications for zoning amendments to undergo planning commission review and recommendation before consideration by the board of supervisors. County staff apparently has been willing to use a streamlined process, in which the two hearings are scheduled only a few days apart. This requires publishing the board hearing notice before the commission even holds its hearing.

The applications being considered in this case involved a tentative subdivision map and zoning amendment, which were processed as follows:

- . January 13: Published notice of the Commissions January 27 hearing.
- . January 20: Published notice of the Boards February 1 hearing.
- . January 27: Commission hearing and decision.
- . January 28: Commission recommendation delivered to Board.
- . February 1: Board hearing and approval.

The commission voted to recommend approval of the subdivision and zoning, but with several alterations to the proposed design and conditions of approval. At the board hearing, five days later, members of the public objected that they had too little time to prepare a response to the commissions recommended changes. It is interesting to note that they did not object to the project, only to the process followed.

The court decided that this procedure violated the strong state policy of encouraging public participation in the planning process. Publishing notice of the board hearing before the commission hearing occurred, setting the two hearings so close together, and failing to publish the actual recommendations, acted to deny the public an adequate opportunity to be aware of the commissions recommendations and comment on them to the board. The court ruled that to properly inform the public, the board hearing notice must include the actual recommendation, and so must wait until after the commission makes its decision and delivers its recommendation to the board in final written form.

I understand cities and counties are complaining that the court applied a strained interpretation of state statutes governing hearings and notice requirements, and may seek reconsideration or appeal. While technically that may be true, it may be difficult to overcome the plain fact that this streamlined procedure does restrict meaningful public participation.

First, participants in the commission hearing may only have a few days to evaluate newly proposed changes, with little time to prepare feedback. Given the tight schedule, the board will not receive new written comments in advance, meaning that in practice the comments may not really be considered in the decision process. (We all have seen how last-minute written submissions are ignored during a public hearing.) This will leave members of the public only 2-3 minutes of public testimony to make their points.

Perhaps more significantly, this practice may result in some members of the public never learning that there is an issue requiring their input. For example, a proposed project may be designed in such a way that neighbors have no objections and so do not participate in the Planning Commission hearing. However, the commission may then recommend changes that might have a material impact on those neighbors (e.g., moving an access road, shifting location of buildings). Newly affected neighbors may not hear of the change in time to attend the board hearing to voice their concerns.

The courts decision raises practical complications. First, the board hearing notice must wait until the commissions decision has been delivered, rather than simply the day after the commission finishes its hearing. In some agencies there can be additional delay as staff writes out its formal report and transcribes the commissions oral motions, including detailed recommended changes to conditions of approval. If staff is uncertain when the report will be completed, it will put off calendaring the board hearing, which may lead to a substantial delay in final approval.

A second issue not discussed by the court involves determining what information must be provided in the hearing notice. State law requires that the notice include a general explanation of the matter to be considered. According to the court, this means that the commissions recommendation must be included. However, the court did not specify how much detail the board notice must contain. The Sierra County Planning Commission made three specific changes to the projects design and conditions; however, more complex projects may result in the commission recommending dozens of revisions. Publishing every detail may result in very lengthy notices, while attempting to summarize the

recommendations may trigger objections and more litigation. If reconsideration is granted, at a minimum the court should clarify this requirement, perhaps allowing a statement alerting the public that changes have been recommended and details are available for review.

There is a strong temptation to streamline the notice and hearing process, on the part of both applicants and staff. This decision applies the brakes on such efforts.

Cross References

. **For discussion of procedures surrounding the adoption and amendment of zoning ordinances**, see Manaster and Selmi, *California Environmental Law & Land Use Practice*, Ch. 60, *Zoning*, § 60.20[1][b] (Matthew Bender).

. **For a procedural guide to obtaining relief from a zoning ordinance**, see *California Legal Forms--Transaction Guide*, Ch. 30B, *Zoning, Building, and Environmental Entitlements and Permits*, § 30B.121 (Matthew Bender).

. *See also* *California Real Estate Law & Practice*, Ch. 265, *Zoning Relief: Amendments, Conditional Use Permits, and Variances*, § 265.13 (Matthew Bender).

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54 of 79 DOCUMENTS

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Eagle on Extent of Diminution in Value to Constitute a Partial Regulatory Taking

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Eagle on Extent of Diminution in Value to Constitute a Partial Regulatory Taking

By Steven J. Eagle

March 4, 2008

SUMMARY: Review Professor Steven J. Eagles expert commentary on the New York appellate court decision in *Noghrey v. Town of Brookhaven*, 2008 N.Y. App. Div. LEXIS 1329 (Feb. 13, 2008), an action to recover damages for a regulatory taking of property without just compensation. The commentary focuses on the key to finding a partial regulatory taking--the extent of the propertys diminution in value.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Diminution in Value as the Key to Partial Regulatory Takings. If a government regulation deprives a landowner of all economically beneficial us[e] of the property, there is a total regulatory taking for which the locality must pay just compensation. *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1019 (1992). If the regulation deprives the owner of less than all value, there may be a compensable taking as well, since [n]othing in the language of the Fifth Amendment compels a court to find a taking only when the Government divests the total ownership of the property; the Fifth Amendment prohibits the uncompensated taking of private property without reference to the owners remaining property interests. *Florida Rock Indus. v. United States*, 18 F.3d 1560, 1568 (Fed. Cir. 1994).

In the controlling U.S. Supreme Court precedent, *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978), the Court acknowledged that it had been unable to develop any set formula for evaluating regulatory takings claims, but identified several factors that have particular significance. *Id.* at 124. Primary among them were [t]he economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations. *Id.* *Penn Central* listed as a third factor the character of the governmental action, giving the example of a physical invasion, as opposed to an economic burden. *Id.* The character test has proved much less important, since four years later the Court held that a permanent physical invasion was a *per se* taking. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

Summarizing its takings jurisprudence in *Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528 (2005), the Supreme Court noted that the *Penn Central* inquiry turns in large part, albeit not exclusively, upon the magnitude of a regulations economic impact and the degree to which it interferes with legitimate property interests. *Id.* at 540. In the Courts first regulatory takings case, Justice Holmes had declared that when the diminution in value reaches a certain magnitude, in most if not in all cases just compensation is required. *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 413 (1922).

The New York Appellate Division Says the Loss Must be One Step Short of Complete. In *Noghrey v. Town of Brookhaven*, 2008 N.Y. App. Div. LEXIS 1329 (Feb. 13, 2008), the plaintiff had purchased two parcels with the intent of building shopping plazas. Thereafter, the town restricted the land to residential use. The owner asserted state and federal takings claims, and the jury subsequently found a partial regulatory taking under *Penn Central*. The Appellate Division reversed and remanded on the grounds that the trial judge's charge was insufficient to convey the extent of diminution necessary to support a taking. The trial judge had charged that the jury might consider whether [the] reduction in value was a *substantial reduction* relative to the value before the properties were rezoned, and that the plaintiff had to prove a near total or *substantial decrease or significant reduction in value*. *Id.* at *4 (emphasis added by Appellate Division).

The Appellate Division mandated that, on retrial, the jury be instructed that the economic impact factor of the *Penn Central* analysis requires a loss in value which is one step short of complete, *Id.* at *7 (quoting *Lucas*, 505 U.S. at 1019 n.8), and that the owner must have been left with a bare residue of value. *Id.* at *78 (quoting *De St. Aubin v. Flacke*, 496 N.E.2d 879, 887 (N.Y. 1986)).

However, the U.S. Supreme Court never has declared that partial regulatory takings are limited to cases where the loss is one step short of complete. The quotation from *Lucas* is in a footnote responsive to Justice Stevens' criticism in dissent that the case was arbitrary because a landowner suffering a total deprivation received just compensation, while a landowner suffering a 95 percent diminution received nothing. The Court responded: This analysis errs in its assumption that the landowner whose deprivation is one step short of complete is not entitled to compensation. It then explained that, for such a landowner, *Penn Central* relief was available. *Lucas*, 505 U.S. at 1019 n.8. Thus, the one step short of complete language referred not to the limit of partial takings under *Penn Central*, but rather to the availability of compensation under *Penn Central* for a landowner in the situation posited by Justice Stevens. Also, the bare residue of value language comes not from a federal court, but rather from a New York Court of Appeals decision that is not the last word on the meaning of the Federal Constitution.

Federal Courts Define Partial Takings Stringently. While *Noghrey* inaptly purports to base its one step short of complete rule on federal case law, it is correct in asserting that most federal courts have required a diminution of value of at least 85 to 90 percent. See *Brace v. United States*, 72 Fed. Cl. 337, 357 (Ct. Cl. 2006), *affd on op. below*, 2007 U.S. App. LEXIS 23752 (Oct. 10, 2007); *Walcek v. United States*, 49 Fed. Cl. 248 (2001), *affd*, 303 F.3d 1349 (Fed. Cir. 2002). Also, a diminution in excess of 90 percent does not necessarily indicate a taking. See, e.g., *Rith Energy v. United States*, 270 F.3d 1347 (Fed. Cir. 2001) (91 percent reduction). On the other hand, in *Florida Rock Industries, Inc. v. United States*, a 73 percent reduction in value was sufficient to indicate a partial regulatory taking, although not dispositive. 45 Fed. Cl. 21 (1999).

Some states have adopted standards similar to that in *Noghrey*. See, e.g., *Animas Valley Sand & Gravel, Inc. v. Bd. of County Commrs*, 38 P.3d 59, 67 (*Penn Central* test requires claimant to show that it falls into the rare category of landowners whose land has a value slightly greater than de minimis). Others have less stringent requirements. See, e.g., *San Antonio v. El Dorado Amusement Co.*, 195 S.W.3d 238, 247 (Tex. Ct. App. 2006), *review denied*, 2007 Tex. LEXIS 523 (Tex. 2007) (40 percent loss in rental income from rezoning supports taking).

There Remains No Set Formula for Partial Regulatory Takings. In *Small Property Owners of San Francisco v. City & County of San Francisco*, the landowner argued that [a] small taking is still a taking. 141 Cal. App. 4th 1388, 1406 (Cal. Ct. App. 2006). The court responded that while a small *taking* is still a taking, a small *loss* is less likely to be a taking. *Id.* Given that the U.S. Supreme Court's *Penn Central* test is applied ad hoc, with no set formula preordaining the outcome, this is the safest starting point for any partial takings analysis.

Cross References

. **For a thorough discussion of the points covered in this commentary**, see Steven J. Eagle, *Regulatory Takings*, 3d ed. (Lexis, 2005).

. **For coverage of takings generally**, see Nichols on Eminent Domain, Ch. 6, *Taking of Private Property for Public Use* (Matthew Bender). Partial takings are discussed in Ch. 14, *Partial Takings: General Concepts*.

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55 of 79 DOCUMENTS

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Bernhardt on Trujillo v. First American Registry, Inc.

2008 Emerging Issues 1918

Professor Roger Bernhardt on *Trujillo v. First American Registry, Inc.*, 157 Cal. App. 4th 628, 68 Ca

By Roger Bernhardt

February 15, 2008

SUMMARY: Get the practical implications of *Trujillo v. First American Registry, Inc.*, 2007 Cal. App. LEXIS 1981, where prospective tenants whose rental applications were denied failed to state a cause of action for violation of the California Consumer Credit Reporting Agencies Act (CCRAA) because they did not establish that reports issued by the defendant that failed to show the dismissal of prior unlawful detainer actions caused them any damage. The court found that the prospective tenants could not state a claim under the CCRAA because it is unconstitutionally vague as applied to unlawful detainer information in tenant screening reports.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *Trujillo v. First American Registry, Inc.*, 157 Cal. App. 4th 628, 68 Cal. Rptr. 3d 732, 2007 Cal. App. LEXIS 1981 (2007) should be read in conjunction with *Ortiz v. Lyon Management Group, Inc.*, 157 Cal. App. 4th 604, 69 Cal. Rptr. 3d 66, 2007 Cal. App. LEXIS 1982 (2007), decided on the same day by the same court and involving the companion Investigative Consumer Reporting Agencies Act (ICRAA) [Cal. Civ. Code § 1786 et seq.].

Both actions suffer from poor selection of plaintiffs that are unlikely to be repeated in future litigation. But better procedural planning will not do much good if the Consumer Credit Reporting Agencies Act (CCRAA) [Cal. Civ. Code § 1785.1 et seq.] is not amended to eliminate the impenetrable defense that was mustered by the coalition of tenant screening agencies, property managers, and residential landlords against the class action plaintiffs.

The statute clearly requires more complete reports of unlawful detainer actions than were furnished by defendant screening agencies. However, this fault did the plaintiffs no good in light of the property managers declarations that they needed no additional information and in fact had been instructed by their client landlords to reject any applicant involved in an unlawful detainer action regardless of its outcome. Those positions meant, according to the opinion, that the plaintiffs had suffered no damage for which the Credit Reporting Act could compensate them. And such testimony will surely be reemployed in later cases in light of the obvious effectiveness it had here.

There is likely to be much pressure on the California Legislature to amend the statute to help tenant plaintiffs overcome this obstacle, but it is not clear how that can be accomplished. Landlords seem satisfied with their method of selecting and rejecting tenants, even if it is not perfect or entirely fair to all tenants. Therefore, it is not easy to foresee how they can be made to demand more thorough screening reports or to read them more diligently or to find some other

method of choosing the tenants they will take in the future. A statutory penalty, apart from the need for actual damages, could be imposed upon incomplete screening reports, but that may increase the cost of such reports beyond what landlords (or tenants) are prepared to pay for them.

The impact of *Trujillo* and its companion *Ortiz* is uncertain. Many of the grounds for rejecting the plaintiffs class claims were based on poor selection of class representatives, which will certainly be remedied by more careful preparation when and if another round of litigation gets started. The problem of the vagueness of the distinction between character information and creditworthiness information that the ICRAA and CCRAA will require legislative action to fix, but there may well be sufficient political strength to make that happen.

What is more difficult to predict is how the pro-tenant forces will solve the lack of damages defense that was used so effectively against them. As written, both the ICRAA and CCRAA require that plaintiffs not only prove improper screening but also show damages that resulted from it, and that cannot be done if the credit reporting agencies can produce property managers who testify that they would have rejected applicants named in unlawful detainer actions regardless of how those actions were concluded, and, even more forcefully, that they -- the property managers -- were instructed to do so by their landlord clients.

That testimony may well be always available to screeners because it is probably not only true, but also cost-free to obtain. Residential landlords are sufficient risk averse as to want to avoid all tenants who are troublesome, whether or not they succeed in their activities; the cost of litigation is itself the bothersome thing. And while landlords are constrained by fair housing laws in their selection of tenants, the classic lists of protected categories (e.g., race, color, religion, sex, sexual orientation, marital or family status, national origin, ancestry, disability) does not include litigiousness. That may be a relevant factor in dealing with retaliatory eviction, but not in tenant selection. And, since the prohibitions against arbitrary selection have been specifically declared to not include income criteria [*see Harris v. Capital Growth Investors XIV* (1991) 52 Cal. 3d 1142, 278 Cal. Rptr. 614, 805 P.2d 873], there is no reason to anticipate that prior lawsuit involvement would be any different. Thus, landlords can probably -- with immunity -- instruct their property managers to not look beyond the preliminary facts of unlawful detainers having been filed in making their determinations, which will render harmless the incompleteness of the reports their screening agencies provide.

Cross References

- . California Forms of Pleading and Practice, Ch. 129, *Consumer Credit Reporting* (Matthew Bender)
- . California Legal Forms--Transaction Guide, Ch. 92, *Service Contracts*, §§ 92.80, 92.81, 92.250, 92.251 (Matthew Bender)
- . Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 2, Creation of Tenancy, 2.23, 2.24, 2.25 (screening fees)
- . Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 5, *Unlawful Detainer*

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56 of 79 DOCUMENTS

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Professor Roger Bernhardt on Ortiz v. Lyon Management Group, Inc.

2008 Emerging Issues 1919

Professor Roger Bernhardt on Ortiz v. Lyon Management Group, Inc., 157 Cal. App. 4th 604, 69 Cal. Rptr. 3d 66, 2007 Cal. App. LEXIS 1982

By Roger Bernhardt

February 15, 2008

SUMMARY: Get the practical implications of *Ortiz v. Lyon Management Group, Inc.*, 2007 Cal. App. LEXIS 1982, where the court found that the California Investigative Consumer Reporting Agencies Act (ICRAA) was unconstitutionally vague as applied to tenant screening reports containing unlawful detainer information. The court found that reasonable persons cannot readily determine whether unlawful detainer information constitutes character information governed by the ICRAA or creditworthiness information governed by the California Consumer Credit Reporting Agencies Act.

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ARTICLE: *Ortiz v. Lyon Management Group, Inc.* (2007) 157 Cal. App. 4th 604, 69 Cal. Rptr. 3d 66, 2007 Cal. App. LEXIS 1982 should be read in conjunction with *Trujillo v. First American Registry, Inc.* (2007) 157 Cal. App. 4th 628, 68 Cal. Rptr. 3d 732, 2007 Cal. App. LEXIS 1981, decided on the same day by the same court and involving the companion Investigative Consumer Reporting Agencies Act (ICRAA) [Cal. Civ. Code § 1786 et seq.].

Both actions suffer from poor selection of plaintiffs that are unlikely to be repeated in future litigation. But better procedural planning will not do much good if the Consumer Credit Reporting Agencies Act (CCRAA) [Cal. Civ. Code § 1785.1 et seq.] is not amended to eliminate the impenetrable defense that was mustered by the coalition of tenant screening agencies, property managers, and residential landlords against the class action plaintiffs.

The statute clearly requires more complete reports of unlawful detainer actions than were furnished by defendant screening agencies. However, this fault did the plaintiffs no good in light of the property managers declarations that they needed no additional information and in fact had been instructed by their client landlords to reject any applicant involved in an unlawful detainer action regardless of its outcome. Those positions meant, according to the opinion, that the plaintiffs had suffered no damage for which the Credit Reporting Act could compensate them. And such testimony will surely be reemployed in later cases in light of the obvious effectiveness it had here.

There is likely to be much pressure on the California Legislature to amend the statute to help tenant plaintiffs overcome this obstacle, but it is not clear how that can be accomplished. Landlords seem satisfied with their method of selecting and rejecting tenants, even if it is not perfect or entirely fair to all tenants. Therefore, it is not easy to foresee how they can be made to demand more thorough screening reports or to read them more diligently or to find some other

method of choosing the tenants they will take in the future. A statutory penalty, apart from the need for actual damages, could be imposed upon incomplete screening reports, but that may increase the cost of such reports beyond what landlords (or tenants) are prepared to pay for them.

The impact of *Ortiz* and its companion *Trujillo* is uncertain. Many of the grounds for rejecting the plaintiffs class claims were based on poor selection of class representatives, which will certainly be remedied by more careful preparation when and if another round of litigation gets started. The problem of the vagueness of the distinction between character information and creditworthiness information that the ICRAA and CCRAA will require legislative action to fix, but there may well be sufficient political strength to make that happen.

What is more difficult to predict is how the pro-tenant forces will solve the lack of damages defense that was used so effectively against them. As written, both the ICRAA and CCRAA require that plaintiffs not only prove improper screening but also show damages that resulted from it, and that cannot be done if the credit reporting agencies can produce property managers who testify that they would have rejected applicants named in unlawful detainer actions regardless of how those actions were concluded, and, even more forcefully, that they -- the property managers -- were instructed to do so by their landlord clients.

That testimony may well be always available to screeners because it is probably not only true, but also cost-free to obtain. Residential landlords are sufficient risk averse as to want to avoid all tenants who are troublesome, whether or not they succeed in their activities; the cost of litigation is itself the bothersome thing. And while landlords are constrained by fair housing laws in their selection of tenants, the classic lists of protected categories (e.g., race, color, religion, sex, sexual orientation, marital or family status, national origin, ancestry, disability) does not include litigiousness. That may be a relevant factor in dealing with retaliatory eviction, but not in tenant selection. And, since the prohibitions against arbitrary selection have been specifically declared to not include income criteria [*see Harris v. Capital Growth Investors XIV* (1991) 52 Cal. 3d 1142, 278 Cal. Rptr. 614, 805 P.2d 873], there is no reason to anticipate that prior lawsuit involvement would be any different. Thus, landlords can probably -- with immunity -- instruct their property managers to not look beyond the preliminary facts of unlawful detainers having been filed in making their determinations, which will render harmless the incompleteness of the reports their screening agencies provide.

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57 of 79 DOCUMENTS

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Danaya C. Wright on Hash v. United States

2008 Emerging Issues 1556

Danaya C. Wright on Hash v. United States

By Danaya C. Wright

December 17, 2007

SUMMARY: In this commentary, rails-to-trails expert Danaya C. Wright examines the effect of the Federal Circuits decision in *United States v. Hash*, explains how--until *Hash* is corrected by a higher court--we are left with a situation in which the government has no retained interest underlying 1875-Act federally granted rights-of-way (FGROWs), and offers one way to protect the federal interest in these railroad corridors while still respecting the *Hash* decision. Cases coming after *Hash* discussed in this commentary include *Blendu v. United States*, *Ellamae Phillips Co. v. United States*, *Brown v. Northern Hills Regional RR. Authority*, and *Home on the Range v. AT&T Corp.*

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ARTICLE: *Hash v. United States*, 403 F.3d 1308 (Fed. Cir. 2005), arises out of a century and a half of contradictory government policies on railroad investment and private landownership and threatens to not only cause further confusion, but also seriously disrupt a century of well-established case law.

From the earliest years of railroad development in this country, Congress has authorized the conveyance to any charter railroad company of a right-of-way across the public lands for the construction of its railroad (federally granted right-of-way, or FGROW). n1 In 1852 Congress passed a general right-of-way act that gave to railroads a 100 right of way, n2 then between 1862 and 1871 Congress gave railroads not only a 100 or 200 right of way through individual acts to railroads, but the fee ownership in alternating sections 10 or 20 miles on each side of their roadbed for sale to raise construction funds. n3 Then in 1875, discontinuing the checkerboard grants in aid, Congress passed another general right-of-way act to give a 200 right-of-way to railroads across all public lands. n4 All of these grants were subject to filing a map of definite location with the department of the Interior, at which time the checkerboard land would be removed from the federal land bank and not be available for patents to homesteaders, and subsequent land patents would be granted subject to the railroads right-of-way. n5 If land had already been patented to homesteaders before the railroad came through, then the railroad had to negotiate privately with the landowners for whatever property rights they needed. n6 But if the land had not been patented, and a right-of-way was conveyed to the railroad, then subsequent land patents would make the patent subject to the railroads right-of-way. A century later, as railroads began abandoning unprofitable lines, the question of who has title to, or possessory rights in, abandoned railroad corridors has become a hotly contested one. n7

The issue in *Hash* is whether land patents to homesteaders conveyed the federal governments underlying (either

servient fee or reversionary) interests in previously granted FGROW at the time the patent was made or whether that interest would transfer, if at all, at the time the railroad's FGROW was forfeited through abandonment. This has important implications for national transportation policy, because in 1983 the National Trails System Act (NTSA) was amended to allow for the preservation of railroad easements or other non-fee simple absolute interests for possible future reactivation, with the possibility of using the roadbed for interim recreational trails. n8 This process, called railbanking, provides that the railroad's state and federal property rights in its corridor land remain in limbo throughout the railbanking period. n9 In 1988, further amendments to the NTSA provided that the federal government's interests in any FGROW would be retained for railbanking purposes, and not be subject to disposal under previous legislation that had given the federal interests either to a municipality through which the right-of-way ran, to a highway department for conversion to a public highway, or to the owner of the land through which the right-of-way ran (the adjacent landowners). n10

The issue itself is relatively simple. If the railroad acquired only an easement from the federal grant, then the underlying fee interest was retained by the government. That interest was either conveyed by a subsequent patent to a homesteader, or excepted out of patents and retained by the government to be used or disposed of as the government sees fit. If the former, then the U.S. has no interest in the underlying fee of these FGROWs (though it might still have an interest in the right-of-way itself); if the latter, then land patentees have no interest in the underlying fee and Congress can amend its laws to dispose of or retain that interest as national transportation needs dictate. If the former, then land patentees will be able to acquire possession of FGROW land when the railroad abandons it; if the latter, then the government can authorize its use for other public municipal, highway, or trails purposes upon abandonment.

While the issues are relatively simple, however, the legal analysis is quite complex in light of the fact that the U.S. Supreme Court has changed its interpretation of what the railroad's interest actually is in FGROW. In 1880 an FGROW was interpreted to convey to the railroad a fee simple absolute interest in the 100 corridor land. n11 In 1903 that interpretation was modified slightly for a different FGROW that was held to contain an implied limitation that would cause reversion of the fee interest upon abandonment by the railroad. n12 That defeasible fee interpretation was followed in 1915 for 1875-Act FGROW (the type of FGROW at issue in *Hash*). n13 To dispose of the government's reversionary interests in these defeasible fees, Congress passed 43 U.S.C. §912 in 1922, which provides that upon abandonment by the railroad, the federal interest will pass either to a municipality through which the road runs, to a highway department that chooses to convert the roadbed into a public highway, or to the adjacent landowner. n14 Notably, the transfer of the federal interest under §912 does not occur until abandonment by the railroad, which is determined only by an Act of Congress or a decision of court of competent jurisdiction. n15 Hence, because the federal interest is retained until the FGROW is abandoned, Congress could certainly amend §912 to stop giving its interest in the right of way to the adjacent landowners if it felt that public policy dictated preserving these federal interests. And that is precisely what Congress believed it was doing in 1988 through the amendments to the NTSA. n16

In the case of FGROWs where the federal grant is a defeasible fee interest, §912 operates after the FGROW has terminated and the fee has reverted back in the U.S. Section 912 then authorizes the transfer of the now unencumbered fee interest to the appropriate recipient, with a clear preference for public over private users. And until 1942, the entire scheme made sense. However, in a case involving a dispute over mineral rights in FGROW, the Supreme Court reversed its 1915 *Stringham* decision and instead interpreted the railroad's interest to be a mere easement that would terminate upon abandonment, but which consisted of a surface possessory right that did not include the minerals. n17 That case, *Great Northern v. U.S.*, changed the nomenclature and, as a result, constricted the railroad's property rights, resulting in an expansion of the government's retained rights. Now, rather than reversionary rights in FGROW, the government would be deemed to have retained the servient fee interest, subject only to an easement in the railroad. The obvious question then became whether §912 would be applicable to 1875-Act rights-of-way that were now held to be easements, since the government's interest was not a reversionary one, but rather a continuously vested fee.

Numerous courts have held that regardless of whether the government's retained interest was the underlying fee or a possibility of reverter, §912 governed the disposition of that interest. n18 And only one court has held, that the government's interest in FGROW passed to homesteaders at the time of original patents and thus was not subject to

§912, but that case is of questionable precedential value. n19 The Federal Circuit in *Hash*, however, has ruled that because the land office did not reserve the underlying fee in the FGROW when it made the land patents to homesteaders, the governments fee interest transferred at the time of the patent. The ruling in *Hash* is limited to 1875 Act FGROW, and does not address whether patentees received the reversionary interest in FGROW made pursuant to other types of federal land grants as defeasible fees. The court did not address the applicability of §912s provisions relating to the abandonment and disposition of FGROW and ignored the cases applying Section 912 to all FGROWs, including 1875 Act grants. Instead, the court held that nothing remained in the governments hands to be disposed of by §912 because the governments interests had been transferred before abandonment. To reach this odd decision, the court relied on a 1906 statute dealing with railroad forfeitures n20 (which arise if the railroad fails to build which was not the case in *Hash*) rather than the statute that deals with abandonments (§912--which arguably was the case in *Hash*).

Besides relying on the wrong statute, the *Hash* decision goes against prior case law finding that homesteaders had no interest in FGROW granted prior to their patents. n21 The District Court for the Northern District of North Dakota stated that the Homesteader cannot reasonably have claimed that in taking a homestead subject to a railroad right of way, he acquired an interest under the right of way. n22 The 8th Circuit upheld this decision, n23 but the Federal Circuit in *Hash* completely ignored these precedents.

Questions raised by *Hash* about timing of property transfers. The *Hash* decision also raises profound questions about the timing of the property transfers. Clearly, if the federal governments entire interest in a section of land passed to a homesteader before a FGROW was granted, then the government has no interest to give to the railroad and the latter must acquire what property rights it needs from the patentee. But if the homestead patent was granted after the railroad received the FGROW, then the governments interest in the underlying fee either transferred at the time of the patent or was retained to be disposed of when the railroad terminates the FGROW through abandonment. Section 912 clearly envisions that the governments retained interest does not transfer until at least one year after a formal declaration of abandonment and only then would the land office make a formal transfer of its property in the FGROW. This delay ensures that other public uses can be made of these corridors. The *Hash* decision completely undermines this public character of §912.

Until it is corrected by a higher court, we are left with the odd situation that the government has no retained interest underlying 1875-Act FGROWs and a conflict in the circuits with respect to the applicability of both § 912 and 16 U.S.C. §1248(c) to 1875 Act FGROW.

But there is one way to protect the federal interest in these corridors while still respecting the *Hash* decision, and that is if the courts ultimately find that, even if the governments underlying fee interest transferred to homesteaders, §912 still applies to the federal governments retained property right, not in the underlying fee, but in the FGROW itself. Because FGROWs were conveyed out of the public lands for transportation and telecommunications needs, and because the government has a clear priority interest in promoting and maintaining national transportation infrastructure, it is quite logical to recognize a federal interest, perhaps a kind of reversionary interest, in the FGROW itself. Thus, the government can authorize the shift in use from railroad to highway or to municipal use under §912, consistent with a recognition that the adjacent landowner will receive unencumbered use of the full fee only when all public uses of the FGROW have been considered and found unnecessary. This result follows from the stringent requirement that FGROWs are not to be deemed abandoned without an Act of Congress or judicial decision looking at the public necessity for these valuable corridors. Once no further public use is to be made, then the FGROW easement will terminate and no further action need be taken. The adjacent landowners can then reacquire full possession of their servient fee. This is the only logical way to harmonize the abandonment statutes and the trails act amendments with the lengthy caselaw applying §912 to FGROW and this anomalous *Hash* decision.

What the *Hash* decision does not do, however, is address the actual question of abandonment of this FGROW by this railroad. Section 912 requires an Act of Congress or decision of a court before a FGROW can be deemed abandoned, and courts have held that decisions by the Interstate Commerce Commission or Surface Transportation Board do not meet that stipulation. n24 Yet, Judge Newman, in the final paragraph of the opinion dealing with the

FGROW issue, concludes, without any predicate analysis, that on the railway's abandonment of its right-of-way these owners were disencumbered of the railway easement, n25 and remanded the case for a determination of just compensation. n26 Not only were the issues of abandonment and takings liability not briefed or argued on appeal, they were not part of the appeal petition, and both sides in the case felt the issues were left unresolved to be settled at trial. Although the Federal Circuit is a court of competent jurisdiction, the absence of briefing or even any findings of fact pertaining to abandonment seriously call into question whether the decision meets the requirements of § 912. And to the extent the district court felt that the Federal Circuit mandated that abandonment had occurred, that court is wrong as well. n27

Finally, even if the federal governments underlying fee interest has transferred to homesteaders, that does not mean the scope of the railroad easement is not sufficient to accommodate interim trail use or to require preservation of the right-of-way in federal hands for future transportation purposes. Hence, we should not conclude from the decision in *Hash* that the railroads interest in its right-of-way is a typical relatively weak common law easement, or even an exclusive railroad easement. Rather, it remains to be determined if it is a transportation easement that is subject to shifting public uses and can be reacquired by the federal government from the railroads without prejudice to the underlying fee owner. It would seem only logical that if the federal government gave away public lands to railroads for transportation and telecommunications purposes, that when the railroads no longer needed them, the lands would return to government control for other public uses. n28 Only if the government determines that the railroad right-of-way has no foreseeable public use should the federal interest terminate and the underlying fee be unburdened. n29

Cases After *Hash*. Unfortunately, the poor reasoning and the very lax final order of the *Hash* decision is beginning to wreak havoc among other courts. First, the district court on remand in *Hash* examined the final paragraph of the Federal Circuit decision, which reads: On the railways abandonment of its right-of-way these owners were disencumbered of the railway easement, and upon conversion of this land to a public trail, these owners property interests were taken for public use, in accordance with the principles set forth in the *Preseault* cases. On remand the district court shall determine just compensation on the conditions that apply to these landowners. n30 As a result, Judge Mikel Williams took this language as a mandate that abandonment had occurred and that railbanking constituted a taking for which just compensation was due. For Judge Williams, the most persuasive evidence that the Federal Circuit had determined both the abandonment and takings liability issues (even though neither were briefed or argued before the Federal Circuit and the parties generally believed they were only appealing the issue of the reversionary interest) was the fact that the Federal Circuit refused to rehear the case on the governments petition for rehearing. Had it accepted the petition to rehear the case it could have spoken to the abandonment and liability issues. But it did not. Consequently, Judge Williams accepted that the railroad had abandoned the corridor (despite having railbanked it) and that compensation was ordered.

To some extent this outcome is merely the consequence of a wrong decision on appeal. Judge Williams had little option given the language of the last paragraph but to accept the landowners claims that the Federal Circuit had made a final decision on abandonment and liability. Were the language in the future tense instead of the past tense the outcome might have been quite different. However, the effects of this somewhat haphazard final paragraph are not limited to the remand in *Hash*, but have extended to another case involving a different landowner on the same railroad corridor as in *Hash*. In that case, *Blendu v. United States*, 75 Fed. Cl. 543 (2007), Judge Hewitt found that the Federal Circuit decision in *Hash* precluded his courts consideration of the merits of the case--namely whether the railroad had abandoned and whether takings liability accrued. Thus, the court granted summary judgment for the landowners and moved directly to assessing takings damages. Both Judge Williams and Judge Hewitt were uncomfortable with the idea that the issues of abandonment and liability were determined once and for all by the Federal Circuit without briefing or argument on the issues, but both felt bound to follow the Federal Circuits rather offhand order.

Not surprisingly, the impact of the *Hash* finding has now moved beyond the narrow scope of the trail at issue in that case, to a trail in Colorado. In *Ellamae Phillips Co. v. United States*, 77 Fed. Cl. 387 (2007), Judge Baskir very reluctantly felt bound to follow the *Hash* mandate on abandonment and liability for 1875-Act FGROW, but did not do so without criticism. As Judge Baskir noted: The absence of any predicate to the Federal Circuits conclusory statement

regarding abandonment is troublesome both for the litigants in *Hash* and for courts attempting to apply correctly precedent in other 1875 Act conversions. The Government thoroughly briefed its non sequitur arguments to the Federal Circuit in its petition for rehearing in *Hash II*. The petition was denied. . . . It is not for a trial court to disregard appellate decisions we think wrongly decided or poorly reasoned. n31 With the extension of the *Hash* mandate to other 1875 Act trail conversions, the courts risk seriously undermining the entire railbanking program and certainly neglect numerous Congressional statements that preservation of rail corridors through railbanking is a high national priority and does not constitute abandonment.

Further reverberations have occurred in the state courts. The Supreme Court of South Dakota has now overruled its prior decision in *Barney v. Burlington Northern RR. Co.* n32 Following the *Hash* finding that no reversionary interests remain in the government for 1875 Act FGROW lands, the South Dakota court in *Brown v. Northern Hills Regional RR. Authority*, 732 N.W.2d 732 (S.D. 2007), held that §912 does not apply to a FGROW and it therefore quieted title to an abandoned corridor in the adjacent landowner. Again, the court was uncomfortable with this finding. After nostalgically reciting at great length the rationale for its decision in *Barney*--especially the role of numerous federal statutes (§§ 912, 913, 1247(d) and 1248(c)) and the legislative history behind these acts--the South Dakota court simply stated that without a reservation in the patents for the servient fee underlying the FGROW, the federal government retained no interest once it issued the patent. It is quite clear from the *Brown* opinion that the court felt *Hash* is problematic--the lengthy and affirmative discussion of the rationale behind the *Barney* decision is contrasted to the very brief and circumspect rationale behind *Hash* that called for *Barneys* reversal.

Hash Decision Limited to Corridors Granted Pursuant to 1875 Act. The only small comfort that can be taken from the *Hash* decision is that it only applies in the case of one type of FGROW--those corridors granted pursuant to the 1875 Act. This was made clear in *Home on the Range v. AT&T Corp.*, 386 F. Supp. 2d 999 (S.D. Ind. 2005), where the district court for the Southern District of Indiana held that the government did retain substantial interests in 1862-1871 FGROWs that would allow for placement of fiber optic cables on those corridors, while finding that *Hash* governed only on the issue of 1875-Act FGROWs. The Indiana court relied heavily on the *Townsend* decision and a decision out of the 7th Circuit n33 that found homestead patentees did not receive the governments interest in those pre-1875 defeasible fee FGROWs. Thus, it is clear that the corridor preservation objectives of § 912 remain intact in the case of other federal grants.

Need for Clarification. But until *Hash* is properly clarified, either by the Federal Circuit itself or a higher court, and the issues of abandonment and subsequent use of these corridors is actually decided through considered legal analysis instead of in an offhand remark, the case may continue to be applied by the courts in a manner that will undermine Congresss clear intention that, upon abandonment, these corridors be made available for continued and future public transportation use.

For additional discussion of rails to trails issues, see Ch. 78A, Rails-to-Trails: Conversion of Railroad Corridors to Recreational Trails, written by Danaya C. Wright in Powell on Real Property (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

Return to Text

n1 . See Danaya C. Wright, Rails to Trails: Conversion of Railroad Corridors to Recreational Trails, Ch. 78A, Powell on Real Property (Michael Allan Wolf, ed., LexisNexis Matthew Bender), § 78A.06[2][f]. Powell

on Real Property. *See* Rails-to-Trails: Conversion of Railroad Corridors to Recreational Trails, written by Danaya C. Wright in Powell on Real Property (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

n2

[2]. Act of Aug 4, 1852, ch. 80, *10 Stat. 28*.

n3

[3]. *See, e.g.*, Pacific Railroad Act of July 1, 1862, ch. 120, *12 Stat. 489*.

n4

[4]. Act of March 3, 1875, ch. 152, *18 Stat. 482*, *43 U.S.C. §§934-939*.

n5

[5]. *Hash v. U.S.*, *403 F.3d at 1311*.

n6

[6]. *Id. at 1312*.

n7

[7]. *See* Wright, *supra* n. 1 at §§ 78A.13 & 78A.15.

n8

[8]. *See* Pub. L. No. 98-11, Title II, *97 Stat. 42* (March 28, 1983), codified at *16 U.S.C. §1247(d)*.

n9

[9]. See Wright, Rails to Trails, in *Powell*, § 78A.11.

n10

[10]. See 1988 Amendments to the National Trails System Act, Pub. L. No. 100-470, 102 Stat. 2281 (Oct. 4, 1988), codified at 16 U.S.C. 1248, amending Pub. L. No. 67-163, 67 Cong. Ch. 94, 42 Stat. 414 (March 8, 1922), codified at 43 U.S.C. §912.

n11

[11]. St. Joseph & Denver City Rr. Co. v. *Baldwin*, 103 U.S. (13 How) 426 (1880).

n12

[12]. *Northern Pacific RR. Co. v. Townsend*, 190 U.S. 267 (1903).

n13

[13]. *Rio Grande Rr. Co. v. Stringham*, 239 U.S. 44 (1915).

n14

[14]. Pub. L. No. 67-163, 67 Cong. Ch. 94, 42 Stat. 414 (March 8, 1922), codified at 43 U.S.C. §912

n15

[15]. Interstate Commerce Commission decision authorizing abandonment was not an act of congress or decision of a court of competent jurisdiction for purposes of § 912. *Barney v. Burlington Northern RR. Co., Inc.*, 490 N.W.2d 726 (S.D. 1992), cert den. 507 U.S. 914.

n16

[16]. See Senate Report 100-408, 1988 U.S.C.C.A.N. 2607.

n17

[17]. *Great Northern R.W. Co. v. U.S.*, 315 U.S. 262 (1942).

n18

[18]. *Marshall v. Chicago & N.W. Transp. Co.*, 31 F.3d 1028 (10th Cir. 1994); *City of Maroa v. Illinois Cent. RR.*, 592 N.E.2d 660 (Ill. App. 4 Dist. 1992); *Barney v. Burlington Northern RR. Co.*, 490 N.W.2d 726 (S.D. 1992) [partially overruled in *Brown v. Northern Hills Regional R.R. Authority*, 732 N.W.2d 732 (SD 2007) which I criticize below]; *Mauler v. Bayfield County*, 309 F.3d 997 (7th Cir. 2002); *King County v. Burlington Northern RR. Corp.*, 885 F.Supp. 1419 (W.D. Wash, 1994); *Whipps Land & Cattle Co., Inc. v. Level 3 Communications, LLC*, 658 N.W.2d 258 (Neb. 2003); *Vieux v. E. Bay Regional Park Dist.*, 906 F.2d 1330 (9th Cir. 1990).

n19

[19]. *City of Aberdeen v. Chicago & NW Transp. Co.*, 602 F. Supp. 589 (D. S.Dak. 1984). Eight years after this decision the South Dakota Supreme Court ruled that § 912 was applicable to FGROW, in 1992, and the 10th Circuit agreed in 1994. And the 8th Circuit affirmed a holding that §912 applied to easement-held FGROW in 1973. See *Barney v. Burlington Northern RR. Co.*, 490 N.W.2d 726 (S.D. 1992); *Marshall v. Chicago & N.W. Transp. Co.*, 31 F.3d 1028 (10th Cir. 1994); *Rice v. U.S.* 479 F.2d 58 (8th Cir. 1973). It is not clear, therefore, that the decision in *City of Aberdeen* is still good law either in South Dakota state courts or in the 8th circuit.

n20

[20]. The Court in *Hash* relies extensively on a 1906 statute and its 1909 amendments that have been codified at 43 U.S.C. § 940. That act provides that any FGROW to a railroad is forfeited back to the U.S. for any portion that is not constructed within five years of the filing of the map of definite location. The Act also provides that the forfeiture shall inure to the benefit of any owner of land conveyed by the U.S. prior to such date without need of further assurance or conveyance. The key to understanding this provision, as well as §912, is that the federal interest does not shift until the railroad forfeits or abandons its FGROW. At that time, and only at that time, does a consideration of the disposal of the underlying governmental interest come into play. Thus, §912, which requires an Act of Congress or a decision of a court of competent jurisdiction before abandonment is declared, insists on a subsequent federal act before property interests shift to municipalities or adjacent landowners.

n21

[21]. The Supreme Court in *N. Pac. RR. v. Townsend* stated that: filing the map of definite location, and the construction of the railroad within the quarter section in question preceded the filing of the homestead entries on such section, [such that] the land forming the right of way therein was taken out of the category of public lands

subject to pre-emption and sale, and the Land Department was therefore without authority to convey rights therein. It follows that the homesteaders acquired no interest in the land within the right of way because of the fact that the grant to them was of the full legal subdivisions. 190 U.S. at 270. And although some have argued that *Townsend* was overturned in 1957 in *U.S. v. Union Pacific RR. Co.*, 353 U.S. 112 (1957), this aspect of the case has never been questioned. This reasoning was also followed in *Rice v. U.S.*, 384 F. Supp. 254 (D. N. Dak. 1972), *affd* 479 F.2d 58 (8th Cir. 1973).

n22

[22]. *Rice v. U.S.*, 384 F. Supp. 254, 257 (D. N. Dak. 1972).

n23

[23]. *Affmd* 479 F.2d 58 (8th Cir. 1973).

n24

[24]. *Barney v. Burlington Northern RR. Co., Inc.*, 490 N.W.2d 726 (S.D. 1992), *cert. den.* 507 U.S. 914.

n25

[25]. 403 F.3d at 1318.

n26

[26]. This holding is clearly dicta, but it has nonetheless been given precedential effect in several other claims court cases. It squarely conflicts with the view of the the court in *Beres v. United States*, 64 Fed. Cl. 403 (2005), which like the Hash court, held that the U.S. did not retain any interest in the underlying fee. Nonetheless, the court in *Beres* held that the United States did not retain an interest in 1875 Act lands, explicitly stated that its ruling by no means resolves the case before the court. There remain numerous issues to resolve before this court can determine if the plaintiffs are entitled to compensation, including resolution of the successor in title to the land *and whether or not there was an abandonment. . . . By this decision, we have taken only one step in a series of steps to determine the property rights and damages claims at issue. Beres v. United States*, 64 Fed. Cl.at 428 (emphasis supplied).

n27

[27]. *See Hash v. United States*, 2007 U.S. Dist. LEXIS 15539 (D. Idaho 2007).

n28

[28]. The broad scope of these FGROWs is indicated by 43 U.S.C. § 934

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[29]. This is clearly the intent of 43 U.S. § 912 when it permits conversion of FGROW to other public highways.

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[30]. 403 F.3d at 1318.

n31

[31]. 77 Fed. Cl. at 395.

n32

[32]. 490 N.W.2d 726 (S.D. 1992).

n33

[33]. *Mauler v. Bayfield County*, 309 F.3d 997 (7th Cir. 2002).

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58 of 79 DOCUMENTS

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James C. Hauser on Graoch Assoc #33 v. Louisville & Jefferson County

2008 Emerging Issues 1577

James C. Hauser on Graoch Assoc #33 v. Louisville & Jefferson County

By James C. Hauser

December 17, 2007

SUMMARY: A landlord might have several reasons for withdrawing from the federal Section 8 Subsidized Housing Program. Could such withdrawal ever violate the Fair Housing Act based solely on its disparate impact to minority tenants? In this expert commentary, the author of the Florida Residential Landlord-Tenant Manual, James C. Hauser, explains why the answer is yes, and discusses what this could mean for landlords and tenants.

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ARTICLE: May Withdrawal from the Section 8 Subsidized Housing Program By Landlord Ever Violate the Fair Housing Act Based Solely on Its Disparate Impact to Minority Tenants?

Section 8 Program. The federal Section 8 housing program, 42 U.S.C. §1437f(b)(1), authorizes the federal government to enter into annual contributions with federal Public Housing Authorities (PHA), so that the PHA may enter into contracts with private landlords. The contract between the PHA and private landlord is that the PHA will pay a portion of the tenants normal monthly rent. As a result a Section 8 tenant will usually pay less than non-Section 8 tenants.

To give an example, an apartment complex charges \$800 a month rent. A Section 8 tenant, based on his/her income may pay \$250 a month and the PHA the remaining \$550 a month. A less affluent Section 8 tenant's portion of the rent might be \$150 and the PHA's \$650. No matter what the scenario, the landlord under the Section 8 program should always receive its normal monthly rent, it is just that a portion will come from the PHA. Thus the Section 8 program has made enormous progress in helping to provide affordable housing to the more disadvantaged segments of society, many of whom are covered under the Fair Housing Act (Title VIII of Civil Rights Act of 1968, 42 USCS § 3601 *et seq.*; abbreviated as FHA).

Facts in Graoch Assocs. # 33, L.P. v. Louisville/Jefferson County Metro Human Rels. Comm'n, 2007 U.S. App. LEXIS 26883 (6th Cir. 2007)

Autumn Run Apartments had previously accepted Section 8 tenants, but decided to opt out of the program. Their reason given was that Housing Authority of Jefferson County (HAJC) had set impossible standards in enforcing housing code violations. There was no evidence that Autumn Run's decision to withdraw from the Section 8 program was made

because it was intentionally discriminating against blacks. Three minority tenants complained about their displacement to the Louisville/Jefferson County Metro Human Relations Commission (LMHRC). LMHRC filed suit in federal court claiming that Autumn Runs **withdrawal** from the **Section 8** program was **racially discriminatory** because it had a **disparate impact on blacks**. Of the seventeen families receiving a Section 8 subsidy, whose leases were not being renewed, all of them were minority. As of the 2000 Census, only 18.9% of Jefferson County, Kentucky were black. **However there was no evidence presented at trial as to what percentage of non-Section 8 tenants who were black, resided at Autumn Run. This omission would turn out to be crucial.** The opinion from the 6th Circuit never discussed whether the problems Autumn Run experienced with the HAJC regarding housing code violations was truly so severe as to constitute a legitimate business interest sufficient to allow Autumn Run to withdraw from the Section 8 program.

Graoch Court's Test to Determine Whether There Is FHA Violation. To determine whether there is a violation of the FHA based on a disparate impact claim against a private individual, a majority of the 6th Circuit adopted the following test.

1. Has the plaintiff made out a prima facie case by showing he is a member of a protected class? A plaintiff does so by identifying the alleged violation and then showing its adverse effect by offering statistical evidence sufficient to prove his/her case.
2. If so, the burden shifts to the defendant to prove it has a legitimate non discriminatory reason for making its challenged decision.
3. If the defendant proves a legitimate business decision, the burden shifts back to the plaintiff to prove that the defendants business reason was a pretext for discrimination or the defendant could have achieved the same business objective using a different approach that would have a less discriminatory impact. n1

All three judges on the 6th Circuit in *Graoch Associates #33 L.P., v. Louisville/ Jefferson County Metro Housing Relations Commission*, 2007 U.S. App. Lexis 26883 (6th Cir. 2007) agreed with opinions from the 2d and 7th Circuits that if a landlord decides **not to enroll** in the Section 8 program, this will **never be a violation of the Fair Housing Act, based on disparate impact**. *Salute v. Stratford Greens Garden Apartments*, 136 F. 3d 293 (2d Cir. 1998); *Knapp v. Eagle Property Management Corp.*, 54 F. 3d 1272 (7th Cir. 1995).

However in *Knapp*, the 7th Circuit went on to hold that if a landlord **does enroll** in the Section 8 program and then decides to **withdraw**, that too will **never** be grounds for a violation of the **FHA based solely on disparate impact**. The 7th Circuits rationale was that if landlords who participate in the Section 8 program could be sued for violations of the FHA, this would discourage landlords from participating in the program in the first place.

All three judges on the 6th Circuit disagreed with the 7th Circuits blanket statement that a landlords decision to withdraw from the Section 8 program could never be a violation of the FHA based on disparate impact. All three judges agreed that there could be certain instances where it was a violation of the *FHA*. *Graoch Associates #33 L.P., v. Louisville/ Jefferson County Metro Housing Relations Commission*, 2007 U.S. App. Lexis 26883 (6th Cir. 2007).

The 6th Circuit gave the following example. An apartment complex is entirely white when the landlord decides to begin participating in the Section 8 program. All of the Section 8 tenants are black. The landlord decides to withdraw from the program and informs the Section 8 tenants that their leases will not be renewed. The 6th Circuit reasoned that the displaced Section 8 tenants should have the right to prove that the landlords decision was either a pretext for discrimination in order to get rid of black tenants or had a disparate impact on black tenants, when an alternative business practice could have achieved the same business ends.

In order to prove a disparate impact case, the plaintiff must prove either the decision has a greater impact on a group protected by the FHA than on a group not protected by the FHA n2 or on the community as a whole. *Arthur v. City of Toledo*, 782 F. 2d 565 (6th Cir. 1986). The case at bar deals solely with the first example. In *Betsey* a decision to

evict families with children n3 meant that 54.3% black families were displaced, but only 14.2% of the white tenants.
n4 As a result disparate impact as to blacks was proven and the landlord was found guilty of violating the FHA.

In the case at bar, although all seventeen families receiving Section 8 tenants whose leases were not renewed were black, there was no evidence concerning what percentage of the entire apartment complex was black. If the entire Autumn Run apartment complex was 95% black, then there obviously could be no disparate impact on the racial composition of the apartment complex with the removal of 17 black families, who happened to receive a Section 8 subsidy. Without such evidence, a majority of the 6th circuit affirmed the lower courts ruling that the landlord was entitled to summary judgment. *Graoch Associates #33 L.P., v. Louisville/ Jefferson County Metro Housing Relations Commission*, 2007 U.S. App. Lexis 26883 (6th Cir. 2007), Moore concurring in part and dissenting in part.

Judge Moore agreed with the majority that under certain circumstances the withdrawal of a landlord from the Section 8 program could constitute a violation of the FHA based solely on the disparate impact it had on minority tenants. However she disagreed as to what test should be applied to prove disparate impact in FHA cases.

Judge Moores Different Test. Her test would be that once the plaintiff makes out a prima facie case, the **burden of persuasion, not proof**, shifts to the defendant that it has a legitimate business interest for its action. Any reference as to whether the business action taken by the defendant was a pretext for discrimination should not be relevant to the inquiry because pretext goes to the question of *discriminatory intent, not to discriminatory effect*. In such a test, the ultimate burden falls on the defendant to prove it has a legitimate business interest and not on the plaintiff that it does not have a legitimate business interest. Judge Moores analysis as to the proper test is compelling.

She would have remanded the case back to the trial court to take further evidence concerning whether Graochs decision to withdraw from the Section 8 program because of the difficulty of working with the local PHA was truly so burdensome as to constitute a valid business necessity. There was never any discussion in the 6th Circuit opinion that the landlord could have taken a less drastic remedy other than eliminating the Section 8 program. For example, perhaps the PHA could have agreed to allow another agency to inspect whether there were truly housing code violations.

Conclusion. A decision by a landlord who *refuses to participate in the Section 8 program at the outset will never constitute a violation of the FHA based on disparate impact*. However **for the first time, a Circuit Court has taken a position that with adequate proof, a Section 8 landlord who attempts to withdraw from the Section 8 program may be held liable for a violation of the FHA based solely on disparate impact and not discriminatory intent**. To put it bluntly, even though a Section 8 landlord never intended to discriminate by dropping out of the Section 8 program, it can still be found liable of violating the FHA. This of course will discourage non-Section 8 landlords from participating in the Section 8 program. See *Knapp v. Eagle Property Management Corp.*, 54 F. 3d 1272 (7th Cir. 1995).

Business Reasons Needed to Withdraw from Section 8. Before a landlord decides to withdraw from the Section 8 program, it must make sure that its business reasons for doing so will pass FHA scrutiny. Simply stating that it no longer wants to participate, without more, will not be enough. Factors such as Section 8 tenants or their guests causing increased vandalism, failure of Section 8 tenants to pay their portion of the rent or disruptive conduct by Section 8 tenants, may be enough to pass judicial muster.

Statistics Required to Show Disparate Impact. On the other side of the coin, plaintiffs attempting to prove that withdrawal from the Section 8 program violates the FHA based on disparate impact better have their statistical ducks in a row. It will not be enough to prove that a majority of the Section 8 tenants displaced are in a class protected by the Fair Housing Act. It must also be proven that the decision to opt out of the Section 8 program will either significantly reduce the number of FHA-protected tenants at the apartment complex or severely reduce the number of apartments available to Section 8 tenants.

For additional discussion of the Fair Housing Act as it affects landlords and tenants, see James C. Hauser, Florida Residential Landlord Tenant Manual, Ch. 13, Discrimination in Rental Housing; Powell on Real Property

§ 16B.09 Protection Against Discrimination in Housing (Michael Allan Wolf, ed., LexisNexis Matthew Bender).

[Return to Text](#)

n1 Compare the 6th Circuit test with 2922 *Sherman Ave. Tenants Association v. District of Columbia*, 444 F. 3d 673, 680 (D.C. App. 2006); *Hack v. President and Fellows of Yale College*, 237 F. 3d 81, 98-102 (2d Cir. 2000); *Langlois v. Abington Housing Authority*, 207 F. 3d 43, 51 (1st Cir. 2000); *Mountain Side Mobile Estates Partnership v. Secretary of Housing and Urban Development*, 56 F. 3d 1243, 1251 (10th Cir. 1995); *Resident Advisory Board, v. Rizzo*, 564 F. 2d 126, 148 n.32 (3d Cir. 1977).

n2 *Betsey v. Turtle Creek Assocs.*, 736 F. 2d 983 (4th Cir. 1984).

n3 The case was decided prior to Congress amending the Fair Housing Act to prohibit discrimination against children.

n4 The remaining 35% of the tenants were not displaced because they did not have children.

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James C. Hauser is a recently retired Circuit Court Judge for the Ninth Judicial Circuit of the State of Florida where he had served since 1990. Previously, he was County Judge in Orange County, in which capacity he was named Jurist of the Year by the Young Lawyers Division of the Florida Bar in 1989. He is a graduate of Boston University School of Law and the Wharton School of Finance at the University of Pennsylvania. Judge Hauser lectures frequently before the bench, bar, and public on the subject of attorney's fees. He is the author for Floridas foremost authority on attorneys fees, *Attorneys Fees in Florida*, Second Edition (LexisNexis). He is also the author *Florida Residential Landlord-Tenant Manual* (LexisNexis). Judge Hauser is available for personal consultations or to lecture on obtaining and maximizing attorney fees and can be reached at 407-951-6685, 9012 Summit Centre Way 102, Orlando, Fla. 32810 or by email at hauserjim@gmail.com.



59 of 79 DOCUMENTS

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Karl M. Scheuerman on Subsequent Condo Developers--Privileges and Rights

2008 Emerging Issues 1583

Karl M. Scheuerman on Subsequent Condo Developers--Privileges and Rights

By Karl M. Scheuerman

December 17, 2007

SUMMARY: Where the developer that creates a condominium is out of the development--whether through foreclosure or bulk transfer to a new developer entity--is the subsequent developer permitted to avail itself of the special rights and privileges contained in the declaration of condominium reserved for the benefit of the creating developer? Karl M. Scheuerman addresses this and related questions in this expert commentary featuring a discussion of relevant arbitration decisions including *Harbourtown at Country Woods v. Unit Owners Voting for Recall*, *Glen Cove Apartments v. Weit*, *Pencor Financial Corp. v. Majestic Tower I*, *Vivienda at Bradenton v. Brittain*, and *Palm Court Owners Association v. Palm Bay Development*.

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ARTICLE: Questions About a Subsequent Developers Authority. A subsequent developers ability to exercise the authority of the creating developer can become a critical issue, especially during stressed economic times. When an original developers inventory of unsold units is foreclosed upon or transferred outright to a subsequent developer, the subsequent developer may wish to take advantage of some right or exemption that had been provided in the declaration to the creating developer. Questions examined in this commentary include

- . whether the subsequent developer may step into the creating developers shoes for purposes of controlling the operation of the association, and

- . under what circumstances the subsequent developer may exercise the rights, privileges, and exemptions of the creating developer provided for in the governing documents.

Several arbitration decisions have considered these issues and offer the perspective of the Division of Florida Land Sales, Condominiums, and Mobile Homes.

Right to Control the Operation of the Association

Rule allows subsequent developer control of board where original developer transferred rights and obligations as described in the rule. Whether a subsequent developer has the right to step into the creating developers

shoes and assume control of the board of directors of the condominium association is an issue that is addressed in part by Florida Administrative Code Rule 61B-23.003(7). Pursuant to the rule, the subsequent developer may continue to exercise the original developers right to control the association where the subsequent developer has obtained an approved assignment of developer rights as described by the rule. An approved assignment under subsection (7)(c) of the rule refers only to a written agreement in which the original developer expressly transfers to the grantee or transferee all developer rights and existing obligations under the declaration and any exhibits thereto. In a nutshell, where the creating developer transfers all its development rights and all of its developer obligations--including warranty obligations--to a subsequent developer by executing an approved assignment of developer rights, among the rights transferred include the creating developers right to control the association. The rule accomplishes this result by providing that the number of units transferred from the creating developer to the subsequent developer do not count towards the sellout percentage provided in the statute for turnover of control. For example, under section 718.301, Florida Statutes, a developer is entitled to appoint or elect a majority of the board of the association until, among other conditions, three years after 50% of the total units to be operated by the association are sold to purchasers, or until 3 months after 90% of the total units are sold to purchasers. By the operation of the administrative rule, where there is an assignment of developer rights, units transferred to the subsequent developer are not counted in the percentage sellout provisions of the turnover statute. Therefore, in a 100-unit condominium, if a certain developer sells 25 of its units to purchasers, then bulk transfers the remaining 75 units to a subsequent developer, the 75 units do not count in the turnover calculation to achieve the 50% or the 90% sellout figures provided in the statute. On the other hand, if there is no assignment of developer rights to a subsequent developer in the afore-stated example, the 75 units would count in the sellout calculation, and turnover would be triggered from the creating developer.

An arbitration case that illustrates another way in which a subsequent developer may acquire the voting rights of the original developer is *Harbourtown at Country Woods v. Unit Owners Voting for Recall*, Arb. Case No. 2005-02-9267, Final Order (July 22, 2004), in which a subsequent developer acquired most of the unsold units owned by the creating developer. The subsequent developer proceeded to recall the creating developers representative on the board, and replaced that director with his own representative. **The arbitrator ruled that that the voting rights of the creating developer passed to the subsequent developer upon the bulk purchase and sale regardless of whether an express assignment was given, and that along with title to the units the subsequent developer acquired the voting rights of the creator that allowed the second entity to vote its newly acquired units in favor of recall.**

Right to Exercise the Original Developers Authority or Exemptions

At Issue Could Be Restrictions Involving Sales or Rental to Individual Owners. An equally intriguing issue is whether a subsequent developer, with or without an assignment of developer rights, may exercise the authority or exemptions given to the creating developer under the declaration. This may arise where a subsequent developer wishes to keep a sales or rental office open on the condominium property where the declaration allows the developer to keep a sales or rental office on the premises, or where the subsequent developer seeks to take advantage of a provision in the declaration exempting the developer from rental restrictions or association review and approval of proposed tenants or purchasers. Whether the new developer may legally take advantage of these rights and privileges that are contained in many declarations of condominium may significantly impact upon the business operation of the subsequent developer.

The arbitration cases of the Division of Florida Land Sales, Condominiums, and Mobile Homes examine the language of the particular declaration to determine whether the drafter intended that the rights or exemptions granted to the creating developer may be exercised by a subsequent or remote developer. Where clear intent exists based on the language of the declaration that the right or exemption was intended to pass through to a remote developer, the decisions allow the subsequent developer to exercise such rights even in the absence of an assignment of developer rights.

Based on definitions and supported by the fact that some privileges were clearly irrelevant after the

condominiums construction, no intent to confer rights and privileges to the subsequent developer was found in *Glen Cove Apartments v. Weit*, Arb. Case No. 93-0075, Final Order (May 30, 1995). In *Glen Cove*, the subsequent developer offered a large number of units for lease in the condominium that it had acquired from FDIC. That developer sought to invoke the creating developers exemption from association approval of leases and residential use restrictions contained in the declaration. The declaration prohibited the association from taking any action that would be detrimental to the sale of units by the developer, and further provided that the developer may use its unsold units and common areas to facilitate the sale of the units including the maintenance of the sales or construction office, the showing of the property, and the display of signs. The term developer was defined in the declaration as the person who creates the condominium or offers units for sale or lease in the ordinary course of business. The arbitrator noted that the definition merely tracked the statutory definition and did not expressly refer to the original developer by name, its successors and assigns, in contrast to the declarations definition of association that included the association and its successors. The arbitrator ruled that there was no overall intent expressed in the documents that the rights and privileges granted to the original developer were intended to benefit remote developers, particularly where the creating developer completed construction. Part of the declaration allowed the developer to change the interior design of the units; this obviously would only apply to the creating constructing developer and did not lend support to the conclusion that the term developer was intended to embrace subsequent developers. Other parts of the declaration allowed the developer to assign original parking spaces and storage bins; this was not found to support a conclusion that the documents intended to confer such authority on subsequent developers. The arbitrator thus rejected the developers arguments to the contrary and ruled that the subsequent developer did not benefit from the rights given to the original developer under the documents. The developer was ordered to submit his prospective tenants to the association for scrutiny, and was ordered to cease operating any unit as a rental or sales office. As stated by the arbitrator: By becoming a remote developer in the absence of an assignment of rights, Weit received none of the rights and exemptions contained in the declaration that benefited the original developer.

Another arbitration case that examines these issues and that perhaps offers a more hopeful model is *Pencor Financial Corp. v. Majestic Tower I*, Arb. Case No. 95-0208, Final Order (Jan. 24, 1996). In this case, the declaration exempted the developer from the associations right of first refusal, and defined developer as the creating developer, its successors and such of its assigns that are assigned its rights by written instrument recorded in the public records. The subsequent developer had in fact obtained a partial written assignment of developer rights from the creating developer. The arbitrator noted that the declaration is a well-drafted document which evinces a clear intent that the original developer shall have and be permitted to exercise the right to assign portions of its rights to successors and assigns. The partial assignment [quoted in the final order] is an equally well-drafted document which clearly indicates the intent of the developer to assign to Pencor a portion of the developer exemption from the associations right of first refusal. The arbitrator further ruled that the word assign was broad enough to include a subsequent developer acquiring units from a foreclosing lender, and stated that a successor described an entity which has, through amalgamation, consolidation or other legal succession become invested with the rights and assumed the obligations of the original entity. Ultimately, the subsequent developer was determined to be entitled as a matter of law to the creating developers exemption from the right of first refusal. It is noteworthy that **the assignment at issue in *Pencor* was not a complete assignment provided for by rule 61B-23.003(7), Florida Administrative Code, applicable in determining whether the subsequent developer acquired the right to control the association; nonetheless the arbitrator allowed the instrument to have its intended effect.**

An additional case that reinforces the ability of a successor developer to exercise such rights is *Vivienda at Bradenton v. Brittain*, Arb. Case No. 95-0043, Partial Summary Final order (Sept. 1, 1995). In that case, the arbitrator held that in a land condominium, the authority of the creating developer to approve improvements constructed within the land unit could lawfully be exercised by a subsequent developer and that such exercise of such authority by the subsequent developer did not impermissibly undermine the right of the post-turnover association to control its own affairs. The declaration in *Vivienda* defined the term developer as the original developer, its designees, successors, substitutes and assigns. The declaration further conferred on the developer, its designees, successors, substitutes and assigns the right to approve all dwellings and improvements constructed with the land unit. There was no assignment in

this case, and the issue thus became whether the documents are properly construed to extend the developer rights and exemptions to a remote developer. **The *Vivienda* opinion contains helpful working definitions of successor and assign and further takes a multi-state tour of available case law on this topic, and concludes that in a broad sense, the subsequent developer was a successor to the original developer, and that the declaration, in providing that all rights of the creating developer inured to the benefit of the developers successors and assigns, benefited the remote developer in this case.**

A final case for discussion is *Palm Court Owners Association v. Palm Bay Development*, Arb. Case No. 95-0131, Final Order (Aug. 14, 1996), in which a subsequent developer attempted to use its units as a sales office and a model. The declaration allowed the creating developer to use its units as models and sales offices, and to modify its units to facilitate such use, but provided that this right only existed until all of the units of the development are sold. **The arbitrator in *Palm Court* ruled that the developers right to use units as models ended by its own terms when all units were sold by the developer, and that in the absence of an assignment of rights or other expression in the declaration that this right was intended to benefit remote developers, the subsequent developer was not able to access this right.** As stated by the arbitrator: The declaration is barren of provisions which would otherwise permit the argument that the drafter intended these rights to benefit remote grantees, to the extent that the declaration even fails to provide a definition of the term developer which in other declarations expressly includes those taking title from the original developer.

Conclusion. A subsequent developers ability to exercise rights and exemptions contained in the declaration in favor of the creating developer under the stated cases is made to depend upon whether an assignment of developer rights was provided with the transfer of units, and independently of the existence of an assignment, whether the language of the particular declaration supports the inference that the drafter intended remote grantees of the original developer to benefit from these provisions.

ABOUT THE AUTHOR(S):

Karl M. Scheuerman graduated from the Florida State College of Law in 1982, and is a leading authority in community association practice. He was Chief Arbitrator with the Division of Florida Land Sales, Condominiums, and Mobile Homes, Florida Department of Business and Professional Regulation, from 1991 to 2006, where he operated the mandatory nonbinding arbitration program of condominium disputes described by section 718.1255, Florida Statutes, and decided many issues involving the proper interpretation of the condominium statute. From 2004 to 2006, he also acted as Chief Administrator for the mandatory mediation and arbitration programs applicable under Chapter 720, Florida Statutes, to homeowners associations. From 1983 to 2006, he was legal counsel for the Division and advised the Division in matters involving administrative rules and interpretation and application of the various statutes under the jurisdiction of the Division. During that time, he represented the Division in administrative hearings, appeals, rule challenges, and before the Legislature. He is a circuit civil mediator, a court appointed arbitrator, and is a member of the Real Property, Probate and Trust Law Section of the Florida Bar, Condominium and Planned Development Committee. He is a contributing author and editor of *Florida Condominium and Homeowners Association Law and Practice* (The Florida Bar, Second Edition CLE 2007), an assistant instructor at the Florida State College of Law Condominium Law Class, and is a frequent lecturer at professional seminars. He has written numerous professional articles in this area of the law.



60 of 79 DOCUMENTS

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Paula A. Franzese on Twin Rivers

2008 Emerging Issues 1552

Paula A. Franzese on Twin Rivers

By Paula A. Franzese

December 17, 2007

SUMMARY: In this Emerging Issues Analysis on the ability of homeowners associations to restrict residents' speech, Paula A. Franzese explains why the New Jersey Supreme Court's decision in *Committee for a Better Twin Rivers v. Twin Rivers Homeowners Assn* is particularly significant.

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ARTICLE: *New Twin Rivers Test Applied to Homeowners Associations'*

Restrictions on Residents' Speech

We are living in the age of the homeowners association. Nearly 60 million Americans now reside in one of the more than 250,000 homeowners associations that are in place across the nation. In the country's fastest growing regions, **common interest communities (CICs)**—the umbrella term used to include condominiums, cooperatives, planned residential subdivisions, and gated and walled developments—represent the dominant form of all new housing.

CICs rely on restrictions and provide services. These rapidly proliferating forms of housing rely on extensive restrictions to privately control land use, services, and conduct. Written by developers and in place from the onset of construction, these restrictions—likened to servitudes that run with the land—function as a kind of privatized zoning smorgasbord, regulating all sorts of matters, from architectural style to landscape design to the posting of signs, the mounting of basketball hoops, the permissibility of pets and even the color of window curtains. Homeowners associations enforce the rules while also providing services traditionally within governments' purview. For example, many CICs maintain streets and parks, operate water and sewer services, retain refuse collection services, hire private security forces, regulate land use, and collect fees and assessments from homeowners that in some ways are the equivalent of local property taxes.

The controversy surrounding privatization. The phenomenon of which CICs are a part is known as privatization,

or the shift from government provision of services to provision by the private sector. Some argue that CICs function as *de facto* mini-governments, and, as such, should be treated as state actors, thereby subject to the constitutional constraints that are imposed on government. Others maintain that CICs are entirely private organizations that are, and should be, exempt from standards intended to protect against state overreaching. Rather, property and contract law appropriately governs these privately consensual rights and duties.

***Twin Rivers* Analysis of CICs as Private Entities.** In July 2007, in a widely anticipated ruling, the New Jersey Supreme Court issued a seminal pronouncement on the rights of residents living in common interest communities. The decision, *Committee for a Better Twin Rivers v. Twin Rivers Homeowners Association*, 192 N.J. 344, 929 A.2d 1060 (N.J. 2007), addressed the scope and extent of free speech rights of residents of CICs. In so ruling, the court determined that CICs are private entities, best governed by private law doctrines of contract and property law. The court made plain that it rejected the premise that homeowners associations, in their functions and powers, had become analogous to municipalities, or quasi-governmental entities. Thus, the restrictions on free speech and association that had been imposed by the Twin Rivers homeowners association were not subject to state actor review, but rather to the rule of reasonableness. As such, those restrictions passed muster.

***Twin Rivers* introduces new constitutional standard.** Significantly, however, the court recognized that, in appropriate circumstances, constitutional protections *do* apply when homeowners associations abridge residents free speech rights. The lynchpin of the court's ruling is contained in this passage, which may well raise more questions than it answers:

We recognize the concerns of plaintiffs that bear on the extent and exercise of their constitutional rights in this and other similar common interest communities. At a minimum, any restrictions on the exercise of those rights must be reasonable as to time, place and manner. Our holding does not suggest, however, that residents of a homeowners association may never successfully seek constitutional redress against a governing association that unreasonably infringes their free speech rights.

Id. at 369, 929 A.2d at 1074.

The *Twin Rivers* decision is not a model of clarity. While a substantial portion of the opinion underscores the premise that homeowners associations are private actors, the court opens the door to the possibility of a constitutional remedy for the private curtailment of speech under appropriate circumstances. The court determined that such circumstances were absent on the record before it, and gave minimal guidance as to when and how its newly fashioned constitutional standard might apply. It may well require years of litigation to more clearly flesh out the contours of the *Twin Rivers* constitutional remedy.

Doctrinal Antecedents: The Federal Analogues

No court in the country has yet determined that CICs should be treated as state actors. Rather, the limited caselaw in this area tends to focus on the contract-based dimensions of homeowner association living. For example, in *Midlake on Big Boulder Lake Condo Assn v. Cappuccio*, the Pennsylvania Supreme Court deemed permissible, under the rubric of freedom of contract, a restriction on residents posting signs without the prior written approval of their homeowners association. 449 Pa. Super. 124, 673 A.2d 340 (Pa. Sup. Ct. 1996).

Nonetheless, some theorists and practitioners have advanced the premise that U.S. Supreme Court precedent offers support for the argument that CICs are the functional equivalent of municipalities. See, e.g., Siegel, *The Constitution and Private Governments: Toward a Recognition of Constitutional Rights in Private Residential Communities Fifty Years After Marsh v. Alabama*, 6 Wm. & Mary Bill of Rts. J. 461, 470 (1998).

In *Marsh v. Alabama*, 326 U.S. 501 (1946), the U.S. Supreme Court ruled that **First Amendment protections extended to certain forms of private property held open for public use**. In that case, the Court found that free speech guarantees were abridged when the private owners of a company town prevented the distribution of literature in its business district. Mindful that the company town shared many of the same key attributes of a municipality, the private owners actions were deemed tantamount to the sort of state action to warrant application of first amendment protections. Two decades later, in *Logan Valley*, the Court deemed shopping centers the functional equivalent of the business district in *Marsh*, thereby subjecting a privately owned mall to the strictures of the First Amendment. *Amalgamated Food Employees Union Local 509 v. Logan Valley Plaza, Inc.*, 391 U.S. 308, 318 (1968).

In *Hudgens v. N.L.R.B.*, the Supreme Court overruled *Logan Valley*, ruling that, **to trigger constitutional scrutiny, private property held open for public use must comprise an entire town**, including residential buildings, streets, a system of sewers, a sewage disposal plant and business block on which business places are situated. 424 U.S. 507, 513 (1976). Hence, privately owned shopping centers are not subject to constitutional constraint when they limit expressive activity undertaken within their domain.

New Jersey Precedent

The Coalition Test as Example of New Jersey's Broad Free Speech Right. New Jersey precedent, construing the State constitutional counterpart to the First Amendment, is more expansive than U.S. Supreme Court precedent. The New Jersey Supreme Court has stated emphatically that precedent, text, structure and history all compel the conclusion that New Jersey's right of free speech is broader than the right against governmental abridgement of speech found in the First Amendment, *New Jersey Coalition Against War in the Middle East v. J.M.B. Realty Corp.*, 138 N.J. 326, 353 (1994) (*Coalition*). For example, **in *Coalition*, the N.J. Supreme Court deemed the private shopping mall the modern-day equivalent of the more traditional town center, thereby subjecting it to state free speech guarantees.** The so-called *Coalition* test to gauge whether a privately owned venue is sufficiently public in character to warrant constitutional curbs on its capacity to abridge expressional activity examines: 1.) the nature, purposes and primary use of such property, generally, its normal use; 2.) the extent and nature of the public's invitation to use that property; 3.) the purpose of the expressional activity undertaken on such property in relation to both public and private use of property. *Id.* Applying those factors, the court concluded that shopping malls are sufficiently public in nature to warrant imposition of free speech standards.

"Historic Path" Set out in *Coalition* is not advanced by *Twin Rivers*. In a telling and oft-cited excerpt from *Coalition*, the court eloquently noted that:

The significance of the historical path of free speech is unmistakable and compelling: the parks, the squares and the streets, traditionally the home of free speech, were succeeded by the downtown business districts. These districts have now been substantially displaced by shopping centers. If our State constitutional right of free speech has any substance, it must continue to follow that historic path.

Id. at 368.

The *Twin Rivers* court declined the opportunity to find that the historic path of free speech has now advanced to private homeowners associations. Rather, the court found none of the three *Coalition* factors satisfied on the record before it. First, it deemed *Twin Rivers* primary use to be residential, notwithstanding the showing that the planned unit development of 10,000 residents is home to several retail businesses and contains streets, including a state highway, that are open to public traffic. Second, the presence of those businesses and public streets did not persuade the court that the public was invited to use *Twin Rivers* property. Third, the court deemed that the limitations on expressional activity?the restrictions on sign posting and use of the community room?were neither unreasonable nor sufficient to find

infringement of a constitutional right.

A New State Constitutional Standard. Rather enigmatically, the *Twin Rivers* court did articulate a new and distinct constitutional standard, to apply to homeowners' associations regulation of expressive activities. At the very least, the court stated, restrictions on the exercise of residents constitutional rights must be reasonable as to time, place and manner. *Coalition*, 192 at 368, 929 A.2d at 1074. For that matter, the court added, its holding is not intended to suggest that residents of a homeowners association may never successfully seek constitutional redress against a governing association that unreasonably infringes their free speech rights. *Id.* at 369, 929 A.2d at 1074. It seems that this new constitutional standard is *sui generis* as concerns homeowners associations, and is meant to implicate a template that is separate and apart from the *Coalition* test. The remedy imposes a test of reasonableness with respect to a homeowners associations regulation of the time, place and manner of residents expressive conduct. It may be that the court intended with this time, place and manner reference to invoke the approach to content-neutral restrictions on speech that has been a traditional hallmark of First Amendment jurisprudence. If so, it remains to be seen whether that well-settled framework will be adopted wholesale, or, as seems more likely, tailored to fit the circumstances and considerations applicable to the residential domain. Most significantly, the *Twin Rivers* court left unresolved the question of the appropriate standard of review to be applied to homeowners associations that abridge free speech rights.

The *Twin Rivers* case is of particular legal moment because of its application (albeit oblique) of a first-amendment type test to homeowners associations, notwithstanding the courts conclusion that those associations are not constitutional actors. The nature and dimensions of that standard remain to be seen.

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Nationally acclaimed for her teaching, Professor Franzese is the unprecedented eight-time recipient of the Seton Hall Law Student Bar Associations Professor of the Year Award. Nominated for the Robert Foster Cherry Prize for Great Teaching, she has been named Exemplary Teacher" by the American Association of Higher Education and was

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In 2006, Professor Franzese was appointed chair of the newly empowered State Ethics Commission by Governor Jon Corzine. In 2005, she was appointed by Governor Corzine to serve on the gubernatorial transition team's Ethics and Policy Management Task Force. In 2004, Professor Franzese and New Jersey Supreme Court Justice Daniel J. O'Hern were appointed Special Ethics Counsel to Governor Codey. In that capacity, they submitted the most comprehensive ethics audit and reform agenda of its kind, resulting in significant ethics reform of the Executive Branch of State Government and promulgation of New Jersey's first Uniform Ethics Code. Their work has garnered national attention, as other states take up the task of ethics reform.

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61 of 79 DOCUMENTS

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Tartaglia on the Home Equity Theft Prevention Act

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Tartaglia on the Home Equity Theft Prevention Act

By Alfred C. Tartaglia

December 15, 2007

SUMMARY: Written by expert Alfred C. Tartaglia, this Emerging Issues Analysis focuses on the Home Equity Theft Prevention Act, its effect on title insurance and its application to overdue mortgage payments.

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ARTICLE: New York Enacts Legislation to Protect Owners of Distressed Properties From Predatory Practices By Purchasers

The Home Equity Theft Prevention Act (HETPA), effective as of February 1, 2007, is intended to prevent abusive and fraudulent practices by purchasers of distressed properties who falsely promise to "save" residential properties and to reconvey them to the homeowners at a future date. The Act regulates certain sales of distressed properties by imposing stringent procedural and substantive requirements for sales contracts ("covered contracts") between homeowners ("equity sellers") and purchasers ("equity purchasers"). Because the Act is broadly worded, imposes potential civil and criminal penalties for violations on both equity purchasers as well as lending institutions, and creates a right of rescission extending for two years after a sale, lenders and title companies are reluctant to insure or lend funds to transactions falling within the Act. In addition, HETPA adds a new procedural step in a mortgage foreclosure proceeding, i.e., the service of a statutory form of notice, which applies in all residential foreclosures, and which is part of a new wave of procedural requirements required in mortgage foreclosures.

Laws added or amended. HETPA amends Banking Law § 595, which sets forth penalties for mortgage bankers, mortgage brokers or banking organizations which fail to comply with HEPTA. HEPTA also adds two new statutes i.e., Real Property Law § 265-a, which contains the bulk of the new substantive and procedural requirements for sales of distressed properties, and RPAPL § 1303, which requires the service of a statutory form of notice in all foreclosures of owner-occupied one-to-four family dwellings.

Effect on title insurance when the transaction falls within HEPTA. Most title companies will not insure a transaction which falls within the act and constitutes a regulated transaction. It is therefore important in many cases to be prepared to establish to the satisfaction of the title company that the a transaction involving a distressed property is

exempt, such as a sale to a purchaser who uses the property as his or her personal residence (*see below*). Title companies often used form affidavits in these circumstances. See Benders Forms for the Consolidated Laws of New York, RPL § 265-a, FORM 3: Purchaser's Exemption Affidavit under the Home Equity Theft Prevention Act; FORM 4: Equity Seller and Equity Purchaser Closing Affidavit: Home Equity Theft Prevention Act. Some title insurers will insure transactions governed by HETPA for an additional fee, although there will be numerous conditions in the policy. See Bagwell, *The Home Equity Theft Protection Act: The Title Company's Perspective*, N.Y.L.J., August 13, 2007, at S6, col. 4.

HETPA applies when residential property is in foreclosure. The Act applies to one-to-four family dwellings which are "in foreclosure," which is defined in Real Property Law § 265-a (2) (g) as meaning that an active notice of pendency has been filed pursuant to RPAPL article 13, or the property is on an active property tax lien sale list. In addition, the property must be the principal residence of the equity seller for HEPTA to apply.

HETPA may also apply when mortgage payments are in arrears. HEPTA also applies when a homeowner is in default of his or her mortgage payments, which is defined as two months or more in arrears. However, the statute is drafted in such a way as to require that a contract of sale of distressed property comply with the Act only "where such contract, agreement or arrangement includes a reconveyance arrangement." RPL § 265-a (2) (c) (ii). This follows from the definition of "covered contract," which is defined as "any contract, agreement, or arrangement, or any term thereof, between an equity purchaser and equity seller which: (i) is incident to the sale of a residence in foreclosure; or (ii) is incident to the sale of a residence in foreclosure or default where such contract, agreement or arrangement includes a reconveyance arrangement." RPL § 265-a (2)(c). The New York State Banking Department and most title insurers construe this provision as meaning that if the written contract of sale of a property for a property which is in default, but which is not in foreclosure, contains no provision for reconveyance to the homeowner, the Act does not apply. See Bagwell, *The Home Equity Theft Protection Act: The Title Company's Perspective*, N.Y.L.J., August 13, 2007, at S6, col. 4; Berey, *Home Equity Theft Prevention Act Took Effect Feb. 1*, N.Y.L.J., March 26, 2007, at 4, col. 4. This interpretation would therefore exclude from the Act's protection conveyances in which a written contract exists which does not contain any reconveyance arrangement, but which may have been induced by unwritten, oral representations of reconveyance made to a homeowner in default. A definitive resolution of the question must await judicial interpretation.

Certain enumerated transactions are exempt. HEPTA does not apply to a bona fide sale to:

1. A purchaser who uses the property as his or her primary residence;
2. A person acquiring title by a deed from a referee in an RPAPL Article 13 mortgage foreclosure;
3. A person acquiring title at any sale of property authorized by statute;
4. A person acquiring title by virtue of an order or judgment of any court;
5. A person acquiring title from a spouse, a parent, grandparent, a child, a grandchild, a child or a sibling of the person or the person's spouse;
6. A purchaser who is a not-for-profit housing organization or a public housing agency; or
7. A bona fide purchaser or encumbrancer for value.

Most title companies will insure title without additional fees based upon the purchaser's affidavit that the property being acquired will be used as the purchaser's primary residence.

A person can be a bona fide purchaser from an equity purchaser, or a bona fide lender to an equity purchaser or a subsequent purchaser, only if he or she had no notice of the equity seller's continuing right in, or equity in, the property prior to the acquisition of title or encumbrance, or of any violation of this Act by the equity purchaser. A bona fide

purchaser or encumbrancer who records an interest prior to the exercise of the equity seller's rescission notice will not be bound by that notice, even if the purchaser or encumbrancer knew that the seller was in default or in foreclosure. What concerns lenders and title insurers is the additional requirement that the bona fide purchaser or encumbrancer must not have notice of the equity seller's continuing right to, or equity in, the property prior to the acquisition of title or encumbrance, or of any violation of this section by the equity purchaser as related to the subject property.

HEPTA is seen as applying to deeds in lieu of foreclosure. Although the Act does not by its terms specifically apply to deeds in lieu of foreclosure, one prominent commentator has pointed out that a viable basis exists for this interpretation. See Bergman, *Home Equity Theft Prevention Act: Measure May Apply to Deeds-in-Lieu of Foreclosure*, N.Y.L.J., June 13, 2007, at 5, col. 2. On the other hand, acquisition of title from the referee in a foreclosure action is clearly exempt from the Act. Weighing the perceived risk of engaging in a covered transaction against the certainty that a foreclosure is exempt, many banks will no longer accept a deed in lieu of foreclosure.

Contractual requirements for purchasing distressed properties from homeowners. Lengthy and detailed requirements are imposed with respect to the content of covered contracts, which must set forth the complete agreement of the parties, including all of the terms of the reconveyance arrangement. These restrictions include contractual requirements. A contract which falls within HETPA must:

Be drafted in 12 point type;

Be written in the English language, or in both English and Spanish if Spanish is the primary language of the equity seller (no other language requirement is imposed by HEPTA);

Set forth the equity purchaser's name, business address and telephone number;

Set forth the address of the residence in foreclosure or in default;

Set forth the total consideration to be given by the equity purchaser to the equity seller;

Contain a complete description of the terms of payment;

Set forth the time at which the equity seller must turn over physical possession of the property to the equity purchaser;

Contain the terms of any rental, lease or reconveyance arrangement. A reconveyance arrangement is defined as "the transfer of title to residential real property by an equity seller who is in default or foreclosure and (ii) the subsequent conveyance, or promise of a subsequent conveyance of an interest back to the equity seller by the equity purchaser that allows the equity seller to regain possession of the property " RPL § 265-a(2)(i);

Contain a statement in the form set forth in the statute in 14 point type advising the purchaser of the right to cancel within 5 days. The statement must be located in the contract immediately above the space for the equity seller's signature. In addition, the covered contract must be accompanied by a form captioned "notice of cancellation" which the equity seller may employ to effectuate the cancellation of the contract; and,

Recite that the deed can be effective no sooner than midnight of the fifth business day after the date of the covered contract. RPL §§ 265-a (4), (6) (a).

The inclusion of any contractual provision limiting the equity purchaser's liability renders the contract void. A list of representations which can not be made by the equity purchaser are set forth, including the requirement that no representations can be made as to the amount of proceeds the seller will get after foreclosure sale.

A presumption exists, which can be overcome by clear and convincing evidence, that an option to purchase retained by the equity seller in the contract or deed is a loan transaction, and the deed is considered to be a mortgage.

Additional requirements for purchasing distressed properties from homeowners. RPL § 265-a (7) (b) contains certain other requirements which are more amorphous than the requirements for written covered contracts. This section provides that an equity purchaser may not make a false or misleading statement regarding:

- the value of the residence in foreclosure or, where applicable, default;
- the amount of proceeds the equity seller will receive after a foreclosure sale;
- the timing of the judicial foreclosure process; any contract term;
- the equity seller's rights or obligations incident to or arising out of the sale transaction;
- the nature of any document which the equity purchaser induces the equity seller to sign;

or any other false or misleading statement concerning the sale of the residence in foreclosure or, where applicable, default, or concerning the reconveyance arrangement.

These additional requirements are particularly of concern to lenders and title companies because they are not readily verifiable, but may nevertheless, if established, result in voiding the transaction within the two year rescission period.

Verification of ability of equity seller to pay for reconveyance. With respect to reconveyance arrangements, the equity purchaser must verify by appropriate documentation that the seller has or will have reasonable ability to pay for reconveyance back according to the standards set forth in Banking Law § 6-1(2)(k) (the Predatory Lending Act). The equity purchaser must either actually reconvey the property, or pay the seller at least 82 percent of the fair market value of the property within 120 days of either eviction or the voluntary giving of possession by the equity seller. The deed must recite that it is subject to reconveyance, and the contract containing the reconveyance arrangements must be recorded with the deed.

Creating remedies for material violations, including rescission. An equity purchaser who "with intent to defraud" violates subdivision seven of Real Property Law § 265-a (e.g., by transferring the property during the first five days of the contract, or making false or prohibited representations) is guilty of a class E felony and subject to imprisonment and a fine of not more than \$25,000. An equity purchaser who "knowingly violates" subdivision seven is guilty of a class A misdemeanor and subject to a fine of not more than \$25,000, imprisonment in accordance with the penal law, or both.

Sales which are found to be in "material violation" of the statute are voidable by the equity seller within two years of the date of the recording of the conveyance to the equity purchaser. Pursuant to Real Property Law § 265-a (8) (a), rescission of the sale is effected by the equity seller giving a notice of rescission to the equity purchaser, or the purchaser's successor(s) in interest, and by recording the notice of rescission in the recording office of the county in which the property is located, within two years of the date on which the conveyance to the equity purchaser was recorded.

A mortgage banker, mortgage broker or banking organization making a mortgage loan with knowledge that the equity purchaser is not complying with Real Property Law § 265-a is subject to penalties under Banking Law § 595-a. The possibility of penalties is in addition to the risk that the seller will either rescind the sale within the five day rescission period, or attempt to void the sale, thereby jeopardizing the encumbrancer's interest in the premises.

Effect of HETPA on bona fide purchasers: A bona fide purchaser or encumbrancer for value under HEPTA is defined as "anyone acting in good faith who purchases the residential real property from the equity purchaser for valuable consideration or provides the equity purchaser with a mortgage or provides a subsequent bona fide purchaser with a mortgage, provided that he or she had no notice of the equity seller's continuing right to, or equity in, the

property prior to the acquisition of title or encumbrance, or of any violation of this section by the equity purchaser as related to the subject property." RPL § 265-a(2)(a). A bona fide purchaser or lienor will not be subject to the equity seller's two-year right of rescission for violations of HETPA pursuant to Real Property Law § 265-a (8) (a). However, by denying bona fide status to a purchaser or lienor who had notice of the equity seller's continuing right to, or equity in, the property, HEPTA appears to place any purchaser or lienor with mere knowledge that a sale fell within the act at peril during the period of the equity seller's two-year right of rescission.

Notice required to be served in foreclosures of owner-occupied one-to-four-family dwellings. RPAPL § 1303 was enacted as part of the Home Equity Theft Prevention Act. It is important to be aware that the statutory notice required by this section must be served in *all* foreclosures of owner-occupied one-to-four family dwellings, and not just those which fall within the definition of "covered contracts" under Real Property Law § 265-a. As originally enacted, RPAPL § 1303 applied to all foreclosures, but it was quickly amended to apply only to residential foreclosures, effective July 3, 2007 (Laws 2007, Ch. 81).

Statutory notice must be in specified type and on colored paper. The RPAPL § 1303 notice must be served with the summons and complaint, and must be in bold, fourteen-point type printed on colored paper that is a color other than that of the paper on which the summons and complaint are printed, with the title of the notice in bold twenty-point type.

No remedy for failure to serve the notice is set forth in the statute. RPAPL § 1303 does not set forth the remedy to be applied if the plaintiff fails to serve the notice, or serves the notice in a form other than that required by the statute. Although some practitioners expected that in the absence of prejudice, any defect would be ignored, the first reported case applying RPAPL § 1303 denied plaintiff an order of reference based on plaintiff's failure to supply *evidentiary* proof that the notice which was served complied with the size and color requirements of the statute. The court held that, "Merely annexing a copy of a purportedly compliant notice does not provide a sufficient basis upon which the Court may conclude as a matter of law that the plaintiff has complied with the statute." *Countrywide Home Loans Inc. v. Taylor*, N.Y.L.J., October 4, 2007, at 28, col. 1 (Supreme Court, Suffolk Co., Peter H. Mayer, J.). Although the *Countrywide* court did not explain what type of showing is required to establish compliance with the statute, presumably, an affidavit is requiring explaining how the plaintiff calculated that the size of the typesetting, and attesting that the original was in a color other than that of the paper on which the summons and complaint were printed. It is also reported that courts in Onondaga County require that a copy of the notice, *on colored paper*, be submitted with an application for the appointment of a referee. Bergman, *supra*, *Home Equity Theft Prevention Act: Measure May Apply to Deeds-in-Lieu of Foreclosure*, N.Y.L.J., June 13, 2007, at 5, col. 2. A cautious plaintiff will therefore submit (1) an evidentiary affidavit explaining how the notice as served complied with the statutes technical requirements, (2) an affidavit of service, and (3) an exact copy of the notice as served, possibly certified, which is on the same colored paper as the original. It must be seen whether other courts will require similarly stringent evidentiary requirements.

Notice and service by publication: As Mr. Bruce Bergman, Esq., points out in *Home Equity Theft: New Law Will Affect Title Insurability, Foreclosure*, N.Y.L.J., October 11, 2006, at 5, col. 2, it is unclear whether the statutory notice must be served when service is made by publication. If the statutory form of notice is published, it will clearly not meet the color and size requirements of the statute.

Service is not expressly limited to service on the mortgagor. The statute does not confine service of the notice to the mortgagor. However, the notice is clearly designed to warn the mortgagor of conduct in violation of the Home Equity Theft Prevention Act, and it is clear that only the mortgagor would benefit from receiving the notice. Service of the notice on other necessary defendants would appear to be unnecessary, and beyond the Legislature's intent. That having been said, some plaintiffs prefer to exercise caution and serve all defendants with the notice.

Related new laws concerning summons or service of process in mortgage foreclosures. RPAPL § 1320 requires specified language to be included in a summons in an action to foreclose a mortgage. The requirement applies to foreclosures of residential property containing not more than three units. This requirement is separate and apart from, and in addition to, service of the separate notice on colored paper required by RPAPL § 1303 for owner-occupied

one-to-four family dwellings. No penalty or remedy is set forth in the statute for failure to comply, nor is any mechanism provided to cure a failure to comply. Presumably, a plaintiff who fails to include the requisite language could seek leave to amend the summons under CPLR 305 (c), which permits the court to amend a summons if a substantial right of a party against whom the summons issued is not prejudiced. When RPAPL § 1320 was enacted, CPLR 3215(g)(3)(i) was amended to include some mortgage foreclosures. A second copy of the summons must now be sent to a defendant when a plaintiff seeks to obtain a default judgment in a mortgage foreclosure action when the defendant is a natural person. The notice must be served at least twenty days before the entry of such judgment. As to exactly when is the best time to effectuate the mailing, practice varies as to whether to serve the notice before or after the actual default in answering. It would appear to be legally sufficient if the additional notice is mailed at the time the action is commenced, or any time thereafter up until twenty days before the entry of judgment. In this regard, it should be noted that CPLR 3215 (g) (3) (ii) specifically provides that the additional notice may be mailed simultaneously with or after service of the summons on the defendant.

For further discussions on the role of the Home Equity Theft Prevention Act, see *Bergman on New York Mortgage Foreclosures § 1.19B* (LexisNexis Matthew Bender); *Warren's Weed New York Real Property: Legislative Update* (LexisNexis Matthew Bender).

For more discussions on mortgage foreclosures, see *Bergman on New York Mortgage Foreclosures* (LexisNexis Matthew Bender); *Bergman on New York Mortgage Foreclosures § 2.02, Goal of the Foreclosure Action* (LexisNexis Matthew Bender); *Powell on Real Property ch. 37, Mortgages and Mortgage Foreclosures* (Michael Allan Wolf ed., LexisNexis Matthew Bender).

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62 of 79 DOCUMENTS

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Scheuerman on Subsequent Developer Control of the Condo Association

2008 Emerging Issues 1528

Scheuerman on Subsequent Developer Control of the Condo Association

By Karl M. Scheuerman

December 14, 2007

SUMMARY: When an original developer of condominium units divests itself of its units through foreclosure or bulk purchase, when does the acquiring entity attain "developer" status, and when is the subsequent developer entitled to vote for a majority of the board of the condominium association? This Emerging Issues Analysis addresses this and related questions of developer status and control.

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ARTICLE: "Developer" Status and the Right to Control the Operation of the Condominium Association. As the sale of new condominium units in the State of Florida continues to falter, certain issues have once again moved to the forefront. These issues include under what circumstances "developer" status is triggered for purposes of being able to vote for a majority of the board of a condominium association, whether an original or subsequent developer may continue to control the operation of a condominium association, and under what circumstances, and whether a particular entity who acquires an inventory of units from the original creating developer? whether through foreclosure or bulk purchase? may be considered a "developer" for purposes of acquiring control of the association.

"Developer" Status Under the Statute and Administrative Rules. Section 718.103(16), Florida Statutes, with certain exclusions not relevant here, defines the term "developer" as a person who creates the condominium or offers condominium parcels for sale or lease in the ordinary course of business. Rule 61B-15.007, Florida Administrative Code, further refines the concept of "developer" to provide that a creating developer is one who creates a condominium, and that a successor or subsequent developer is a person other than the creating developer who offers parcels for sale or lease in the ordinary course of business. Rule 61B-15.007, F.A.C., in turn defines the phrase "offering condominium parcels in the ordinary course of business." According to the rule, a person who offers more than 7 parcels in a condominium comprised of more than 70 parcels, or who offers more than 5 parcels in a condominium comprised of 70 or fewer parcels, in the course of a year, is offering parcels in the ordinary course of business.

Thus, it is seen that developer status is conferred under the statute and rules on an entity that either creates the condominium or who offers the indicated number of parcels for sale or lease in the ordinary course of business. The fact that the rule identified above is located in the section of the rules describing a "developer" for purposes of filing

disclosure documents with the Division of Florida Land Sales, Condominiums, and Mobile Homes of the Department of Business and Professional Regulation is of no import as the rule is the only guidance available in determining "ordinary course of business." Moreover, there is no reason to restrict the application of the rule to the filing context, and in fact, as reported later in this Emerging Issues Analysis, the arbitration decisions that have considered this issue have invariably adopted this definition.

Statutory Guidance Addressing When a Creating Developer Is Allowed to Control the Operation of the Association. Section 718.301, Florida Statutes, sets forth the framework for determining when a developer is entitled to control the operation of a condominium association by electing or designating a majority of the board of directors of a condominium association. Basically, the statute provides a percentage sellout formula that ensures that at a certain sellout point in the sales of the units, unit owners other than the developer will become entitled to elect a majority of the board. For example, within 3 months of when the developer sells 90% of the units to be operated by the association, the developer is required to relinquish control of the association to the residents. The time at which control is turned over to the residents is referred to as turnover of control. Turnover is important in that it triggers the ability of the resident-controlled association to commence certain types of litigation including warranty litigation. Also, when the developer loses control of an association, the developer loses the ability to set the level of assessments and to adopt the budget, as well as the ability to determine the level of maintenance for the project which may impact the future sales of the developer. Turnover of control also triggers the ability of the owner-controlled association to cancel certain types of management contracts. Finally, many documents provide that a developer's guarantee of assessments under section 718.116, Florida Statutes, ends at turnover, at which point the developer is required to start paying assessments on its remaining inventory. Turnover also requires that the developer prepare a turnover audit to verify that an association's assessment monies during the period of developer control were spent for bona fide association expenses.

Most significant for our purposes is that the turnover statute in section 718.301(1)(c),(d), Florida Statutes, also requires turnover when the developer stops offering parcels *for sale* in the ordinary course of business. Consequently, under the plain operation of the statute, and independently of what percentage of units have been sold, where a developer removes its inventory of units from the sales market, assuming that construction of the units has been completed, turnover is triggered at that point. The statute does not provide a safe harbor from the requirement of turnover for the developer who stops offering units for sale, but instead begins a rental program for the inventory of units. Thus, where a developer stops offering its units for sale, but commences a rental program for the unsold units, turnover is instantly triggered under the statute.

A Subsequent Developer and Its Ability to Control the Association Under the Statute and Administrative Rules. While section 718.301, Florida Statutes, is most easily understood as describing the turnover process where a creating developer is in control of the association, many of the general elements of the statute also apply to a subsequent developer's ability to control the association. In other words, while in all likelihood section 718.301, Florida Statutes, was drafted to primarily address the creating developer's ability to control, this part of the statute is not on its face made applicable only to creating developers but instead applies to all "developers," whether creating or subsequent. While the percentage sellout provision of section 718.301, Florida Statutes, only makes sense when applied to the creating developer and finds no application when applied to a subsequent developer as the original inventory of the creating developer has already been sold or otherwise transferred, the other elements triggering turnover find easy application to subsequent developers, to wit: When a "developer" fails to offer its units *for sale* in the ordinary course of business, the developer is no longer permitted to vote for a majority of the board. Thus, considering only the statute at this point, a developer?whether subsequent or creating?who stops offering his parcels *for sale* is no longer entitled to control and is required to call and hold the turnover election.

This is the exact pronouncement contained in rule 61B-23.003(7), Florida Administrative Code. However, the rule initially addresses the subject of a bulk transfer of units from the creating developer to a subsequent entity/transferee, and provides that absent an approved assignment of developer rights, the units conveyed in the bulk transfer count towards the sellout percentages that trigger turnover. As an example, absent an assignment of developer rights, if the creating developer sells 25 units in a 100-unit condominium to purchasers, then bulk sells its remaining 75 units to a

separate entity, the transfer of the 75 units counts towards calculating the total units sold by the developer, such that turnover under the 90% sellout provision of section 718.301, Florida Statutes, is triggered, requiring turnover within three months. If an approved assignment of developer rights is used whereby the creating developer transfers all its developer rights to a subsequent entity, the number of units sold in the bulk transfer is not counted in the sellout calculation and the subsequent entity in effect steps in the shoes of the creating developer. Experience suggests that most bulk transfers are not accompanied by an assignment of developer rights.

Rule 61B-23.003(7), Florida Administrative Code also addresses under what circumstances a bulk transferee may vote for a majority of the board where there is no assignment of developer rights. Under subparagraph (e) of the rule, if the transferee of a bulk transfer does not become a developer by offering parcels for sale or lease in the ordinary course of business, that entity may vote for a majority of the board. Under these circumstances, such a transferee is not a "developer" but is simply a unit owner. There are no relevant restrictions in the statute or rules that prohibit a unit owner from voting for a majority of the board. A subsequent entity that simply acquires the remaining inventory of the creating developer and does nothing with the units never becomes a developer and may vote for a majority of the board. However, as explained in subparagraph (f) of the rule, if the transferee offers the parcels for sale or lease in the ordinary course of business, such transferee loses unit owner status and becomes a developer. Once this occurs, a subsequent developer who offers its parcels *for sale* is entitled to vote for a majority of the board, but a subsequent developer that only offers its parcels *for lease* in the ordinary course of business is never entitled to vote for a majority of the board. The rule is consistent in its operation with the turnover provisions of section 718.301, Florida Statutes, which trigger turnover once a developer ceases to offer its units for sale in the ordinary course of business. Thus it is seen that the rule extends the basic statutory turnover concepts to subsequent developers by allowing subsequent developers to vote for a majority of the board so long as there is an active ongoing sales effort. Whether a subsequent developer actually succeeds in electing a majority of the board is a function of the number of unit votes held by the entity compared to the number of non-developer votes cast in the election.

The Court Cases and the Arbitration Decisions. A singularly significant appellate opinion dealing with the ability of a subsequent developer under the statute to control the association is the case of *Bishop Associates v. Belkin and Division of Florida Land Sales, Condominiums, and Mobile Homes*, 521 So. 2d 158 (Fla. 1st DCA 1988). Where a group of ten limited partnerships acquired a number of units from the original developer and offered them for lease and not for sale in the ordinary course of business, the Court affirmed the declaratory statement of the Division holding that the partnerships were subsequent developers who were not entitled to control the board of the association. The opinion also sheds insight on the intended operation of the turnover statute: "A general review of Chapter 718 reveals that it was created to facilitate the transfer of control of the association from the developers to non-developer unit owners." *Id.* at 162. Simply stated, if the statute allowed leasing developers to control the association, the designated sellout percentages would never be achieved and turnover would never occur. By affirming the Division's declaratory statement, the Court implicitly validated the underpinnings of rule 61B-23.003(7), Florida Administrative Code.

A case that merits a comment in passing is the case of *First Federal Savings and Loan Ass'n. v. Department of Business Regulation*, 472 So. 2d 494 (Fla. 5th DCA 1985) where the Court held that a savings and loan association that accepted deeds from the developer in lieu of foreclosure cannot be deemed a developer even where it sold one unit to one buyer and ten units to another buyer. Among other reasons, the Court found that the savings and loan association had not "offered" parcels, and that it did not do so in the ordinary course of its business: "If this were 'ordinary' for a mortgagee, it would not long continue in the lending business." Obviously, the *First Federal* case preceded the advent of the RTC. In response to the opinion, the Division amended its administrative rules to define ordinary course of business in terms of the number of units offered, and further amended its rules to provide an exemption from the offering definition where the transferee offers and sells all its units to a single purchaser, such as a financial lending institution receiving title through foreclosure and conveying all its units to a single purchaser.

The arbitration decisions also follow the framework of the statute and administrative rules in determining developer status and in determining whether a developer may vote for a majority of the board. In *Cail v. Sebastian Harbor Villas Condominium Owners Association*, Arb. Case No. 94-0084, Final Order (Aug. 27, 1994), the arbitrator held that where

several investors acquired a number of units from the FTC and offered them for lease in the ordinary course of their business, thereby becoming developers, they were not entitled to vote for a majority of the board as they were not offering their units for sale in the ordinary course of business. In this case, the developers had claimed to be offering units for sale, but this claim was rejected by the Division arbitrator where no unit had actually been sold for a period of years, where the units had not been offered for sale on a listing service or otherwise regularly advertised for sale, and where there was no meaningful effort to conduct a sales program. This case suggests that the issue of whether units are offered for sale is a fact-specific issue that will depend on all the factors found in the case. The lack of a bona fide and meaningful sales effort will likely lead to a finding that the units are not being offered for sale in the ordinary course of business.

In the arbitration case of *Central Florida Investments v. Sand Lake Village*, Arb. Case No. 2003-07-1426, Final Order (Dec. 18, 2003), the arbitrator held that where the owner of a number of units in the condominium did not offer its units for sale or lease, but used a portion of the units for storage and offices, the entity was not a developer, but was a mere unit owner and as such was entitled to vote for a majority of the board. However, the arbitrator noted that developer status may change over time depending on the activities undertaken by the owner. It is most likely that once the entity begins a sales or lease program, its status would accordingly change to that of a developer.

In *Glen Cove Apartments Condominium Association v. Unit Owners Voting for Recall*, Arb. Case No. 00-1395, Final Order (Sept. 15, 2000), developer status precluded participation in a recall. The arbitrator found that where two entities offered their units for sale or lease in the ordinary course of business, the entities constituted subsequent developers, and were precluded from recalling unit owner representatives on the board under an administrative rule providing that only unit owners may vote to recall unit owner representatives. It can be seen, therefore, that developer status has significance outside the direct election of board members.

In the arbitration case of *Story v. David William Hotel Condominium Association*, Arb. Case No. 95-0251, Final Order (Dec. 28, 1995), the arbitrator held that where the general partners of the creating developer limited partnership entered into an agreement to sell their rights in the partnership to new entities that were to act as the new general partners of the partnership in continuing the business of the partnership, the transfer of partnership rights did not result in a new partnership and the transfer did not count towards the percentage sellout provisions of the statute.

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Karl M. Scheuerman graduated from the Florida State College of Law in 1982, and is a leading authority in community association practice. He was Chief Arbitrator with the Division of Florida Land Sales, Condominiums, and Mobile Homes, Florida Department of Business and Professional Regulation, from 1991 to 2006, where he operated the mandatory nonbinding arbitration program of condominium disputes described by section 718.1255, Florida Statutes, and decided many issues involving the proper interpretation of the condominium statute. From 2004 to 2006, he also acted as Chief Administrator for the mandatory mediation and arbitration programs applicable under Chapter 720, Florida Statutes, to homeowners associations. From 1983 to 2006, he was legal counsel for the Division and advised the Division in matters involving administrative rules and interpretation and application of the various statutes under the jurisdiction of the Division. During that time, he represented the Division in administrative hearings, appeals, rule challenges, and before the Legislature. He is a circuit civil mediator, a court appointed arbitrator, and is a member of the Real Property, Probate and Trust Law Section of the Florida Bar, Condominium and Planned Development Committee. He is a contributing author and editor of *Florida Condominium and Homeowners Association Law and Practice* (The Florida Bar, Second Edition CLE 2007), an assistant instructor at the Florida State College of Law Condominium Law Class, and is a frequent lecturer at professional seminars. He has written numerous professional articles in this area of

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63 of 79 DOCUMENTS

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Robert D. Butters on BUC International Corp. v. International Yacht Council

2008 Emerging Issues 1485

Robert D. Butters on BUC International Corp. v. International Yacht Council

By Robert D. Butters

December 13, 2007

SUMMARY: In this Emerging Issues Analysis on the copyrightability of fact-based databases, especially real estate multiple listing services, Robert D. Butters explains not only why the BUC case is a major copyright protection victory for owners of such databases but also why such owners should be careful in relying on copyright protection, and what steps they should consider in addition to copyright registration.

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ARTICLE: The Supreme Court's *Feist* decision set the ground rules when it considered the copyrightability of data in telephone book. One of the most confusing areas in copyright law is the extent to which fact-based databases are entitled to copyright protection. In 1991 the United States Supreme Court in *Feist Publications, Inc. v. Rural Telephone Service Company*, 499 U.S. 340 (1991), considered whether the "white pages" of a telephone book are entitled to copyright protection. The Court determined that copyright protection only extended to "creative works." Therefore, "raw facts," such as persons names, addresses, and telephone numbers, are not entitled to any copyright protection regardless of how much time, effort, and resources the compiler may have expended in aggregating the data into a central database.

Copyright protection for originality in selection, arrangement, and presentation. The Court then noted that fact-based compilations can qualify for copyright protection if the compiler shows originality in the selection of the particular facts to include in the compilation, and in the manner in which the selected facts are arranged and presented to users of the compilation. The copyright protection is available, however, only for the components of the compilation that embody the compiler's originality, and not to the facts themselves that may be contained in the compilation. Turning to the copyrightability of the telephone white pages, the Court concluded that arranging a list of persons' last names in alphabetical order, together with their addresses and telephone numbers, was such an obvious system of organization that it lacked even the barest amount of originality necessary to qualify for copyright protection.

Post-*Feist* cases address degree of originality necessary to qualify a database for copyright protection. Since *Feist*, copyright practitioners and database compilers have grappled with the degree of originality that must be demonstrated in the selection, arrangement and presentation of facts in a database to qualify for protection under the

copyright law, and when a second comes copying of the components of a database constitutes copyright infringement.

Applicability to Real Estate MLS. Among the database compilers most concerned with copyrightability of their database compilations are operators of real estate multiple listing services, which often contain hundreds of thousands of records of real estate parcels that are actively for sale, are subject to a pending contract, have been withdrawn from the market, or have sold for a particular price. The real property data contained in a real estate multiple listing service is increasingly valuable to other businesses providing services incident to the closing of a real estate transaction, such as mortgage lenders, appraisers, and title companies. For this reason, real estate multiple listing services are legitimately concerned about their ability to maintain control over the data in their database compilations.

The Eleventh Circuit's BUC holding. The Eleventh Circuit recently addressed these issues in *BUC International Corporation v. International Yacht Council*, 489 F.3d 1129 (11th Cir. 2007). While the *BUC* case addresses the copyright protection afforded to a compilation of data about yachts for sale, its analysis and holding are directly applicable to any other fact-based database, including real estate multiple listing services. In *BUC*, the plaintiff began as a publisher of a hard-copy used boat price guide that listed individual boats and yachts for sale as well as relevant market values. In the late 1980s the plaintiff automated his guide and promoted it to yacht brokers as a centralized compilation of yachts for sale that the brokers could use to match listed yacht sellers with interested buyers. Participating yacht brokers signed license agreements with the plaintiff that permitted the brokers to access, search, view, and print the data in the plaintiff's compilation. The plaintiff also created a standardized format that yacht brokers were to use when submitting information to the database about a yacht that they had listed for sale. Brokers could, however, use an alternative format if it was more appropriate for the presentation of the data about a particular yacht. Over ninety percent of the yachts listed for sale in the plaintiff's compilation used the plaintiff's standardized data presentation format.

In 1997, the plaintiff registered his copyright claims in the "compilation, selection, and organization" of his yacht listing database, as well as the accompanying text describing each yacht. The plaintiff also placed a copyright notice on each yacht listing record in the database. In June of 2000, the defendant Florida Yacht Brokers Association formed a subsidiary called the International Yacht Council Limited for the express purpose of creating an online multiple listing service for yacht listings. Shortly after its organization, the Council engaged a third-party company, defendant MLS Solutions, to assist it in the creation of its online yacht multiple listing service.

When the Council launched its yacht MLS, it encouraged all Florida-based yacht brokers to send their listings to MLS Solutions by fax or email. Since most yacht brokers were already licensees of plaintiff's database, they simply copied their listings from the plaintiff's database and forwarded them to MLS Solutions. In some cases, MLS Solutions employees acquired the passwords and access codes to plaintiff's database from plaintiff's licensees and used them to copy the yacht listings in the plaintiff's database. When he learned of this practice, the plaintiff placed "markers" on the listings in his database to identify those listings when they later appeared in the Council's MLS.

In 2002, the plaintiff sued the Council and MLS Solutions for copyright infringement and secured a preliminary injunction to halt any further copying of the plaintiff's listings. The case was tried to a jury, which returned a verdict of over \$1.5 million for the plaintiff. On appeal, the Eleventh Circuit considered defendants' argument that the plaintiff's database lacked sufficient "originality" to qualify for copyright protection under the Supreme Court's decision in *Feist*.

The plaintiff, not the yacht brokers, was the "author" of his compilation. The Eleventh Circuit rejected the defendants' first contention that the "authors" of the plaintiff's compilation were the yacht brokers because the brokers were free to deviate from the plaintiff's standard format and submit their yacht data in any manner they chose. The court noted that only two percent of the listings in the plaintiff's database were in other than the plaintiff's standard format. The court's holding on this point is significant because the data contained in the plaintiff's database in fact originated entirely from the yacht brokers, and not from the plaintiff himself. Generally, databases are created by a single compiler who itself gathers the data and arranges it in the database. In *BUC*, however, the compiler simply provided the format into which others submitted the actual data found in the database. The court determined that the critical factor

determining the "authorship" of the compilation is the creation of the data format, not who gathered and submitted the data. Since nearly all of the data in the database was arranged according to the plaintiff's standardized format, the plaintiff was deemed to be the "author" of the compilation. The same analysis would be applicable to a real estate multiple listing service into which real estate brokers and agents submit data about listed properties. Since the MLS designs the format used by the brokers and agents when submitting the property data, the MLS, and not the brokers, is the "author" of the MLS compilation for copyright purposes.

The plaintiffs idea and his expression of that idea were not merged. The defendants also contended that the plaintiffs compilation was not original because of the merger doctrine, which provides that a non-protected idea is merged with the protected expression of the idea when there are only one or two effective ways of expressing a particular idea. The defendants argued that the merger doctrine should apply to deprive the plaintiff of any copyrightable interest in his database because there is, for all practical purposes, only one way to present data about a yacht that is for sale. The court rejected the defendants argument finding, first, that, in this case, the noncopyrightable idea is the concept of delivering relevant information about yachts for sale to yacht brokers and buyers and sellers, and not, as defendants argued, the concept of identifying the factual information about a yacht that would be of interest to potential buyers or brokers. In reaching its conclusion, the court also noted that the record contained evidence that, prior to the plaintiffs creation of his standardized format, different information about yachts for sale were presented in a variety of formats.

The defendants infringed on the plaintiffs copyright because the defendants data presentation format was substantially similar to that of the plaintiff. Finally, the court considered and rejected the defendants argument that the plaintiffs database compilation of standardized records describing yachts for sale was not sufficiently original under the *Feist* standard to justify protection under the copyright law. The court began by noting the evidence that prior to plaintiffs introduction of his database the information sources and formats about yachts for sale was a hodge podge. The court then considered, but declined to follow, the holding of the Middle District of Florida in *Nautical Solutions Marketing, Inc. v. Boats.com*, No. 8:02-CV-760-T-23TGW, 2004 U.S. Dist. LEXIS 6304, 17 Fed. L. Weekly Fed. D. 635 (M.D. Fla., April 1, 2004). In *Nautical Solutions*, the court held that a copyright claimant in a fact-based database can successfully establish an infringement only if the claimant can show that the alleged infringers data presentation format was virtually identical to that of the claimant. The Eleventh Circuit rejected the virtually identical standard and instead reaffirmed the substantially similar standard that it had announced in the post-*Feist* cases of *Bell South Advertising & Publishing Corp. v. Donnelly Information Publishing, Inc.*, 999 F.2d 1436 (11th Cir. 1993) and reaffirmed in *Warren Publishing, Inc. v. Microdos Data Corp.*, 115 F. 3d 1509 (11th Cir. 1997 (en banc)). The court then held that the trial courts instruction that the jury could find for the plaintiff if the defendants format for the presentation of yacht data was substantially similar, even if not virtually identical, to that of the plaintiff was not reversible error.

The substantially similar standard affords considerably greater protection to copyright claimants in database compilations than the virtually identical standard. Under the virtually identical standard applied in the *Nautical Solutions* case, a second comer can avoid a copyright infringement attack simply by adopting cosmetic variations in its data presentation format from that of the original compiler. The Eleventh Circuits substantial similarity test, however, permits a copyright claimant to succeed on an infringement claim if there is a reasonable degree of similarity between the claimants format and that adopted by the defendant, even if the formats are not virtually identical. Second comers, in turn, must now significantly alter their data presentation format from that of the original compiler, or run a significant risk of a successful infringement

action.

The BUC case in perspective. The BUC case is a major victory for compilers of fact-based database compilations, and especially those in which the data maintained in the compilations is supplied by third-party users of the compilations. The *BUC* case establishes that the author of the copyrightable components of the database is the database aggregator that created the format in which the data is to be entered into the database, as opposed to the third parties who actually gather and enter the data in the first instance. The *BUC* case also makes clear that a second

comer who substantially copies the original compilers data presentation format will be liable for copyright infringement.

On the other hand, the *BUC* case does nothing to diminish the *Feist* principle that copyright protection does not extend to the raw facts contained in a database compilation. Therefore, Internet search engines that use spiders to extract factual information from real estate brokerage or real estate multiple listing service websites, and then reformat the information on another website, are not liable for copyright infringement so long as the manner in which the data is reformatted is not substantially similar to the manner in which it appeared on the original website. Operators of real estate multiple listing services, or compilers of other fact-based databases, are well advised to place only limited reliance on copyright law to protect their compilations.

Consider these steps in addition to copyright protection.

1. Copyright registration should be supplemented by carefully drafted license agreements that strictly control those who may access the compilers database and the uses that licensees may make of the data to which the compiler grants them access.
2. As did the plaintiff in the *BUC* case, database compilers should also mark their records, or insert dummy seed records, n1 that, if found in another database, is evidence that the records originated from the compilers database.
3. Finally, online database or website operators should utilize rigorous data security measures to thwart the ability of unauthorized persons to gain access to nonpublic portions of the databases or websites.

[Return to Text](#)

n1 "Seeding" is the practice of putting false names or data points into a database for the purpose of detecting unauthorized copies of the database. If a compiler sees similar data on another site or compilation, the compiler can search for one of its "seed" names or data points. If the "seed" name or data point appears in the database, the compiler knows it originated from its database. The term "mark" is sometimes also used in this context to mean placing a distinctive "mark" on a data record that indicates where it originated. If copies appear on other sites with the "mark," then this is evidence of unauthorized copying.

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Robert D. Butters is a partner with Arnstein & Lehr LLP in Chicago, Illinois and has practiced law for more than 25 years. His practice focuses on the representation of companies and associations that engage in, or serve, the real estate and real estate brokerage businesses. Mr. Butters also represents clients in matters involving electronic commerce, antitrust, civil rights and equal housing opportunity, professional and fiduciary liability, administrative law, professional licensing, and the acquisition, protection and licensing of proprietary rights in computer software and electronic databases. From 1986 to 1992, Mr. Butters served as Deputy General Counsel to the National Association of Realtors, the world's largest professional association. He has also served as an antitrust trial attorney in the Federal Trade Commission's Bureau of Competition in Washington, D.C. Mr. Butters also assists his professional association clients in the organization and operation of affiliated foundations and charitable and taxexempt organizations. Mr. Butters is the author of "Real Estate Brokers and Antitrust Laws" and "The Impact of Electronic Commerce on the Real Estate

Brokerage Business," both published by LexisNexis Matthew Bender in the treatise entitled Real Estate Brokerage Law and Practice. Mr. Butters has delivered numerous speeches and presentations at seminars sponsored by professional associations and government agencies on legal and liability issues facing the real estate and related industries with particular emphasis on electronic commerce matters.

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64 of 79 DOCUMENTS

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Professor Steven J. Eagle on Crown Point Development, Inc. v. City of Sun Valley

2008 Emerging Issues 1483

Professor Steven J. Eagle on Crown Point Development, Inc. v. City of Sun Valley

By Steven J. Eagle

December 13, 2007

SUMMARY: *Get Prof. Steven J. Eagles Emerging Issues Analysis on Crown Point Development, Inc. v. City of Sun Valley, 2007 U.S. App. LEXIS 25511 (9th Cir. 2007), where the court found that a developer could state a substantive due process claim based on the city's allegedly arbitrary and irrational denial of its permit application.*

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ARTICLE: *Crown Point Development, Inc. v. City of Sun Valley, 2007 U.S. App. LEXIS 25511 (9th Cir., Nov. 1, 2007), makes clear that the U.S. Supreme Court recognizes an independent substantive due process remedy for landowners arbitrarily deprived of their property. However, the widely-applied "shocks the conscience" test still thwarts owners' ability to obtain relief.*

Prohibition of Substantive Due Process Claims by Landowners Abrogated. In *Armendariz v. Penman*, 75 F.3d 1311 (9th Cir. 1996) (en banc), the Ninth Circuit held that the Fifth Amendment's Takings Clause subsumes or "preempts" substantive due process claims. *Armendariz* was based on two lines of U.S. Supreme Court cases. In *Graham v. Connor*, 490 U.S. 386 (1989), and *Albright v. Oliver*, 510 U.S. 266 (1994), the Court held that claims of excessive force and wrongful prosecution had to be analyzed under the more specific provisions of the Fourth or Eighth Amendments rather than under the more subjective standard of substantive due process. Also, in *Agins v. City of Tiburon*, 447 U.S. 255, 260 (1980), the Court declared in dicta that regulations that do not "substantially advance legitimate state interests" implicate the Takings Clause as well as the Due Process Clause.

The Supreme Court disavowed its *Agins* formulation in *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528, 543 (2005). *Lingle* also held that the "substantially advances" inquiry probes the regulation's underlying validity, an inquiry both grounded in due process, and "logically prior to and distinct from" a takings analysis.

Crown Point agreed that *Lingle* had undermined *Armendariz* so as to permit the claim that a land use regulation was "wholly illegitimate." Given that *Armendariz* was the leading case opposing substantive due process review of property deprivations, its abandonment in *Crown Point* concludes a process commenced immediately after *Lingle*, and having its roots in earlier cases. *Consolidated Waste Systems, LLC v. Metro Gov't of Nashville*, 2005 Tenn. App. LEXIS

382 (Tenn. Ct. App. 2005) (not reported in S.W.3d).

The Independent Importance of Property Deprivation Claims. The explicit validation of the landowner's right to bring a substantive due process claim is important. While regulatory takings claims suffice when landowners want only just compensation, substantive due process claims may invalidate actions unjustly depriving owners of title and possession.

One obvious example is the ability of a substantive due process claim to defeat an eminent domain action where the intended beneficiary of the action is a private party. While *Kelo v. City of New London*, 545 U.S. 469 (2005), held that a taking for retransfer for private economic development did not violate the Public Use Clause of the Fifth Amendment, the Court made clear that pretextual takings for private use would not pass constitutional muster.

Another example is where government deprives owners of property, but arguably does not arrogate the property to itself. An example is *Casitas Municipal Water Dist. v. United States*, 76 Fed. Cl. 100 (Fed. Cl. 2007), where irrigation water belonging to the plaintiff was diverted for the purpose of fish habitat protection. Although the government's assertion that it was "regulating" the water made this plausibly not a taking, as the court held, owners similarly burdened might be able to argue that they arbitrarily had been deprived of a valuable asset.

The Standard for Violation of Substantive Due Process Is Very Strict. While landowners now are free to bring substantive due process actions against the federal government under the Fifth Amendment, and against states and localities under 42 U.S.C.S. § 1983, their chances of prevailing are small. Most U.S. Circuit Courts of Appeals employ a variant of the test developed by the Supreme Court in the context of a high-speed police chase. See *County of Sacramento v. Lewis*, 523 U.S. 833, 845846 (1998). There, the Court stated that only the "most egregious" or "conscience shocking" official conduct is "arbitrary in the constitutional sense." Furthermore, there is a split among the circuits about whether the ownership of property necessary to bring a substantive due process claim relates to ownership of the parcel for which a development application is made [see, e.g., *DeBlasio v. Zoning Bd. of Adjustment*, 53 F.3d 592, 600 (3d Cir. 1995)], or only to instances where the municipality had no discretion in granting the application [see, e.g., *Nichols v. Bd. of County Comm'rs*, 2007 U.S. App. LEXIS 24706 (10th Cir. 2007)].

The Supreme Court has employed rational basis review so as to meaningfully determine whether land use restrictions were plausibly related to their purpose in *City of Cleburne v. Cleburne Living Center*, 473 U.S. 432 (1985) (invalidating stricter zoning for group homes for the retarded than for hotels and fraternity houses). Such meaningful due process review might be expanded. Furthermore, although the First Circuit in *Mongeau v. City of Marlborough*, 492 F.3d 14, 1718 (1st Cir. 2007), recently applied the shocks-the-conscience standard to a land use determination, the court noted: "We have never precluded a plaintiff from arguing that conduct that is the product of a deliberate and premeditated decision might be conscience-shocking whereas the same conduct might not be if it was undertaken in the heat of the moment."

Cross References.

. For a thorough discussion of the points covered in this Commentary, see *Regulatory Takings*, 3d ed. (Lexis, 2005).

. For a summary of the facts and holdings in *Crown Point Development, Inc. v. City of Sun Valley*, 2007 U.S. App. LEXIS 25511 (9th Cir. 2007), including additional commentary on the case, see 12 California Environmental Law Reporter 9 (Dec. 2007) (Matthew Bender).

. For coverage of the application of substantive due process to economic and property rights, see Manaster & Selmi, *California Environmental Law & Land Use Practice*, Ch. 60, *Zoning*, § 60.50[2][d] (Matthew Bender). For discussion of takings claims generally, see Ch. 65, *Takings and Other Constitutional Controls*, in that treatise.

. *See also* *Zoning and Land Use Controls*, Ch. 52A, *Regulatory Takings: Theories, Causes and Remedies* (Matthew Bender).

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65 of 79 DOCUMENTS

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Michael Allan Wolf on Westchester Day School v. Village of Mamaroneck

2008 Emerging Issues 1391

Michael Allan Wolf on Westchester Day School v. Village of Mamaroneck

By Michael Allan Wolf

December 7, 2007

SUMMARY: The general editor of Powell on Real Property, Michael Allan Wolf, explains why even more valuable than the holding in this pro-plaintiff decision by the United States Court of Appeals for the Second Circuit may be the three clues that the Second Circuit panel provides in dictum regarding those kinds of government regulatory actions that would not trigger landowner protections under the Religious Land Use and Institutionalized Persons Act.

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ARTICLE: In Zoning Dispute, the 2nd Circuit Affirms that RLUIPA Has Been Violated, Refuses to Find RLUIPA Unconstitutional, and Gives 3 Hints About What Regulatory Actions Would Not Trigger Landowner Protections Under RLUIPA

Churches, synagogues, temples, mosques, and other religious organizations seeking to expand or build their facilities all too frequently find themselves at odds with local zoning authorities. It is often difficult to distinguish the run-of-the-mill zoning dispute, in which a landowner is frustrated by a government officials refusal (based on ordinary, sound planning principles) to grant development permission, from those situations involving invidious and illegal government discrimination directed toward the landowners (or its members) beliefs or practices. The pro-plaintiff decision by the United States Court of Appeals for the Second Circuit in *Westchester Day School v. Village of Mamaroneck*, 2007 U.S. App. LEXIS 24267 (2d Cir. 2007), might at first glance seem to restore religious landowners to the favored status they often enjoyed before 1990. Upon close study, however, the decision has much more in common with those relatively rare cases in which non-religious owners have triumphed over arbitrary or unfair zoning officials.

The Legislative Attack on *Smith* (Times Two). Ever since 1990, when a five-member majority of the United States Supreme Court in *Employment Division v. Smith*, 494 U.S. 872 (U.S. 1990), refused to apply the balancing test established in *Sherbert v. Verner*, 374 U.S. 398 (U.S. 1963) to a neutral, generally applicable law, religious individuals and groups have felt especially vulnerable to a wide range of government regulation, particularly in the area of land use. Under the *Sherbert* test, governmental actions that substantially burden a religious practice must be justified by a compelling governmental interest. *Smith*, 494 U.S. at 883. Because zoning and other regulations and restrictions on land use are typically deemed neutral, generally applicable laws under *Smith*, religious bodies that own land would, in the absence of a change in federal law, be treated the same as their secular neighbors. Accordingly, local government zoning authorities would be entitled to the same generous deference they have been accorded ever since the Supreme

Court decided in *Euclid v. Ambler Realty Co.*, 272 U.S. 365 (U. S. 1926), that a landowner carried the heavy burden of demonstrating to the court that a local governments zoning decision is arbitrary, capricious, or unreasonable, bearing no real relationship to the traditional goals of the police power, those goals typically being the protection of health, safety, morals, and the general welfare.

Congress responded to *Smith* by passing the Religious Freedom Restoration Act of 1993 (RFRA), codified at 42 USCS §§ 2000bb to 2000bb-4, with strong bi-partisan support in both chambers in the White House. This was a direct attempt to restore the compelling governmental interest and least restrictive means aspects of *Sherbert* to a wide range of governmental activity that burdened the free exercise of religion. This first legislative response proved fruitless, however, at least as far as state and local government regulation was concerned, when the Supreme Court struck down the non-federal aspects of RFRA in *City of Boerne v. Flores*, 521 U.S. 507 (U.S. 1997). In this RFRA-based challenge brought by the Catholic Archbishop of San Antonio, Texas, because of the denial of a building permit for enlarging a church in an historic district, the majority found that Congress had overstepped its enforcement powers under Section 5 of the Fourteenth Amendment. Justice Anthony Kennedy wrote:

Legislation which alters the meaning of the Free Exercise Clause cannot be said to be enforcing the Clause. Congress does not enforce a constitutional right by changing what the right is. It has been given the power to enforce, not the power to determine what constitutes a constitutional violation.

Boerne, 521 U.S. at 519. Concluding that RFRA contradicts vital principles necessary to maintain separation of powers and the federal balance, *id.* at 536, the Court reversed the lower courts opinion that the Act was constitutional. In a short concurrence, Justice John Paul Stevens opined that the Act also amounted to an unconstitutional violation of the Establishment Clause, noting: This governmental preference for religion, as opposed to irreligion, is forbidden by the First Amendment. *Id.* at 537 (Stevens, J., concurring).

Refusing to be outflanked by the High Court, Congress went back to the drawing board, producing the Religious Land Use and Institutionalized Persons Act of 2000 (RLUIPA), codified at 42 USCS § 2000cc to 42 USCS § 2000cc-5, a statute with a more limited scope (as suggested by its title) that articulated alternative constitutional foundations for restoring the compelling governmental interest and least restrictive means features of *Sherbert*. The first time a frontal challenge to RLUIPA reached the Supreme Court, in 2005, the justices responded favorably. In *Cutter v. Wilkinson*, 544 U.S. 709 (U.S. 2005), Ohio correctional officials, responding to RLUIPA-based claims brought by inmates, unsuccessfully asserted that the statute violated the Establishment Clause. *Westchester Day School* is one of several land use RLUIPA cases to reach the federal circuit court level since passage of the Act in 2000. *See, e.g., Sts. Constantine & Helen Greek Orthodox Church, Inc. v. City of New Berlin*, 396 F.3d 895 (7th Cir. 2005) (finding a substantial burden); *Guru Nanak Sikh Soc'y v. County of Sutter*, 456 F.3d 978 (9th Cir. 2006) (finding a substantial burden and upholding the constitutionality of RLUIPA); *San Jose Christian College v. City of Morgan Hill*, 360 F.3d 1024 (9th Cir. 2004) (holding that, because there was no substantial burden, RLUIPA did not come into play); *Primera Iglesia Bautista Hispana of Boca Raton, Inc. v. Broward County*, 450 F.3d 1295 (11th Cir. 2006) (finding no RLUIPA violation); and *Midrash Sephardi, Inc. v. Town of Surfside*, 366 F.3d 1214 (11th Cir. 2004) (finding RLUIPA violation and holding that the statute is not unconstitutional). To date, the Supreme Court has yet to grant *certiorari* in this variety of cases. For a valuable Internet site on the statute (sponsored by the Becket Fund for Religious Liberty), which includes summaries of leading cases, see RLUIPA.com.

Substantial Dictum (Times Three). *Westchester Day School* is not the first zoning case in which a federal court has found a substantial burden under RLUIPA. **Even more valuable than the actual holding of the case are three clues that the Second Circuit panel provides in dictum regarding those kinds of government regulatory actions that would not amount to a substantial burden and thus would not trigger landowner protections under the Act.**

1. First, the court observes, at *13, that it is not enough for a religious school to demonstrate that the proposed improvement would enhance the overall experience of its students. The court provides three examples of construction projects that would not meet the crucial test—a gymnasium, headmasters residence, or additional office space.

Westchester Day School provides the court with an extreme set of pro-landowner facts, as every classroom being constructed will be used at some time for religious education (at *15). **By identifying those physical changes requiring public approval that would not trigger RLUIPA, the court is sending a subtle warning to those religious landowners who would seek to wrap their nonreligious activities in this statutory cloak.**

2. The second important hint that the panel provides to government land use regulators who want to avoid RLUIPA suits is to avoid absolute, unconditional denials. Judge Cardamone observes, at *17-*18, that when the denial of a religious institutions application to build is not absolute, such would not necessarily place substantial pressure on the institution to alter its behavior, since it could just as easily file a second application that remedies the problems in the first. Moreover, the court notes, at *18-*19, that if there is a reasonable opportunity for the institution to submit a modified application, the denial does not place substantial pressure on it to change its behavior and thus does not constitute a substantial burden on the free exercise of religion. **Local and state governments in the territory of the Second Circuit and beyond should heed this panels injunction to be moderate and flexible.** In a similar manner, the Supreme Court in *Williamson County Reg'l Planning Comm'n v. Hamilton Bank*, 473 U.S. 172 (U.S. 1985), explained that only when a landowner has obtained a final decision from land use regulators will a regulatory takings claim be ripe. It is, in other words, the final no" that poses the greatest risk for government officials.

3. The third important instance of dictum appears in the following sentence, at *19: We recognize further that where the denial of an institutions application to build will have minimal impact on the institutions religious exercise, it does not constitute a substantial burden, even when the denial is definitive. Even when the construction project is indisputably linked to religion, and even when the governments answer is a definitive, unconditional, and final no, the defendant can still prevail. The court explains, at *19, that [t]here must exist a close nexus between the coerced or impeded conduct and the institutions religious exercise for such conduct to be a substantial burden on that religious exercise, and provides an instructive example of when that nexus would be absent: a situation where a school could easily rearrange existing classrooms to meet its religious needs in the face of a rejected application to renovate. There is therefore symmetry in the courts reasoning: not only is the court encouraging the *government* regulators to be flexible, but also **the religious landowner may be called upon to adjust its land use activities in order to avoid the accusation that it is claiming a burden that would be easily avoided, if not self-imposed.**

A Return to *Sherbert* or to *Cleburne*? Stripped of its federal statutory and constitutional elements, the opinion in *Westchester Day School* looks suspiciously like judicial review of an unfair or arbitrary decision to deny a special use permit request that is unsupported by the record. Consider, for example, the following statement, at *26, that could easily be found in any state-court zoning decision involving the denial of a zoning change: the record convincingly demonstrates that the zoning decision in this case was characterized not simply by the occasional errors that can attend the task of government but by an arbitrary blindness to the facts. Indeed, in the very next sentence, the panel reports, As the district court correctly concluded, such a zoning ruling fails to comply with New York law. One very curious aspect of this decision is that the court seems to suggest that the religious landowner might have to demonstrate that a zoning decision is already suspect under state law for it to amount to a substantial burden that would trigger relief under RLUIPA. If that is the case, then perhaps RLUIPA is nothing more than a federal supplement to state land use and zoning law? a federal hammer (with attorneys fees thrown in) that is designed to prevent local land use regulators from acting in an arbitrary or capricious manner.

What I am suggesting is that *Westchester Day School* is essentially a first cousin of the Supreme Courts decision in *City of Cleburne v. Cleburne Living Ctr.*, 473 U.S. 432 (U.S. 1985). In *Cleburne*, the justices, even using minimal scrutiny (the rational basis test) found that the decision of city officials to require that the operator of a group home for the mentally retarded secure a special use permit in a residential zone rest[ed] on an irrational prejudice, *id.* at 450, and therefore violated the Equal Protection Clause. The zoning officials of Village of Mamaroneck, by heeding the public opposition of the small but influential group of neighbors, at *10, rather than sound planning principles, may have fallen into the *Cleburne* irrationality trap. The passage of time (during which we will see decisions in many more RLUIPA

cases) will tell whether the substantial burden requirement of the statute is merely a proxy for the traditional arbitrary and capricious test that has governed zoning law for more than eight decades.

For further discussion of RLUIPA, see *Powell on Real Property* § 79D.02 (Michael Allan Wolf ed., LexisNexis Matthew Bender), *Zoning and Land Use Controls* § 40.03 (Eric Damian Kelly, ed., LexisNexis Matthew Bender), *Zoning Law and Practice* § 37-3 (LexisNexis), *Regulatory Takings* § 5-2 (LexisNexis), and *Land Use Law Supp.* to § 5.70 (LexisNexis).

For further discussion of Equal Protection challenges to zoning decisions, see *Powell on Real Property* § 70.04 (Michael Allan Wolf ed., LexisNexis Matthew Bender), *Zoning and Land Use Controls* § 35.04 (Eric Damian Kelly, ed., LexisNexis Matthew Bender), *Zoning Law and Practice* § 3A-1 (LexisNexis), *Regulatory Takings* § 1-8 (LexisNexis), and *Land Use Law* § 2.48 (LexisNexis).

For further discussion of ripeness in regulatory takings cases, see *Powell on Real Property* § 79E.06 (Michael Allan Wolf ed., LexisNexis Matthew Bender), *Zoning and Land Use Controls* § 52A.05 (Eric Damian Kelly, ed., LexisNexis Matthew Bender), *Zoning Law and Practice* § 3-19 (LexisNexis), *Regulatory Takings* § 8-6 (LexisNexis), and *Land Use Law* § 2.26 (LexisNexis).

This expert commentary also appears in the LexisNexis Real Estate Report Volume 2, Issue #7 .November 2007.

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66 of 79 DOCUMENTS

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Professor Roger Bernhardt on Morgan Creek Residential v. Kemp

2008 Emerging Issues 1379

Professor Roger Bernhardt on Morgan Creek Residential v. Kemp

By Roger Bernhardt

December 6, 2007

SUMMARY: *Get Professor Roger Bernhardt's Emerging Issues Analysis on Morgan Creek Residential v. Kemp, 153 Cal. App. 4th 675 (Cal. Ct. App. 2007), a case that held a real estate developer was not entitled to contribution because the loan guarantors and the developer did not share the same level of liability.*

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ARTICLE: *Morgan Creek Residential v. Kemp, 153 Cal. App. 4th 675, 63 Cal. Rptr. 3d 232 (2007), review denied, 2007 Cal. LEXIS 12572 (Oct. 31, 2007), raises issues that have probably not occurred to most attorneys and, because of its unsatisfying resolution of those issues, will require extensive counseling and cautious drafting by counsel in many loan transactions.*

The Problem: Secondarily Liable Parties. The basic problem is that when a mortgage loan is further secured by the signatures of several secondarily liable parties, the resolution of their rights inter sese when one of them pays more than her proper share of the common obligation. This is resolved very unsatisfactorily in California. The common law rule that a party who pays a disproportionately larger share is thereafter entitled to seek contribution from his fellow obligors -- which seemed to be codified in Cal. Civ. Code § 1432 and Cal. Civ. Code § 2787 -- was in this case subjected to the additional restriction that both parties must have the same level of liability for contribution to happen. Because the secondarily liable party who had been forced to pay the lender had executed a letter of credit, he was not entitled to seek contribution from the other secondarily liable parties who had executed guarantees (that were not called on for that payment). Since a letter of credit is expressly stated in the code not to be a suretyship obligation like a guarantee, and because the independence principal that characterizes a letter of credit is not a feature of a guarantee (even though guarantors are permitted to waive the anti-deficiency protections that debtors have precisely because their obligations are independent), the right of contribution did not apply.

This means that whenever there are two or more secondarily liable persons behind a loan, they cannot automatically assume that a default rule will equalize their burdens automatically if one is called on to pay more than her fair share. A court, at least in California, could conclude that their differing levels of liability prohibit that outcome.

But what kind of differences in their secondary liabilities that might be deemed sufficient enough as to deny contribution is unknown. A court could find that two guarantors have different levels of liability simply because one

waived some defenses that the other did not -- or because one secured her guarantee with real estate whereas the other did not. Since the court in *Morgan Creek Residential* used the different levels of liability not to alter or adjust the amount of contribution but rather to deny it entirely, the opinion raises a concern that all secondary obligors must face unless they are not bothered by the prospect of one being a winner and the other a loser when the lender determines to go against only one of them. If that is not what they want, they must alter it by contract between them.

Mutual Execution of Agreement. Common obligors -- whether secondary or not -- can mutually execute an agreement that provides for the rights of which ever one who is required to pay a disproportionate share to recover an equalizing share from the other, and decide among themselves on the mechanism for doing so. This inter-obligor agreement would be separate from their agreements with the lender and any primary debtor who is in the picture. Rather than work out all of the details, it may be sufficient for them merely to declare that they desire to have the statutory principle of contribution, as stated in *Civ. Code § 1432*, to apply to them regardless of whether a court determines that their liabilities are at different levels. It is to be hoped that such a brief statement will suffice since this is almost inevitably the outcome they would select at the outset when it is unknown what may later happen to the success of the loan.

Equitable Subrogation. The decision in this case also prohibits the party who pays a disproportionate share from seeking equitable subrogation from the other. It is uncertain whether that result could be changed by agreement. Where the payment, as here, only partially satisfies the debt and leaves the creditor still secured, the requirement that equitable subrogation always requires full payment will defeat its application in this context. If the secondary party paid the entire debt, she would be subrogated to the rights of the creditor against the debtor, but it is unclear as to whether she would also have subrogation rights against the other secondary party or how such rights could be exercised.

Cross References

- . California Forms of Pleading & Practice, Ch. 300, *Indemnity and Contribution* (Matthew Bender)
- . California Forms of Pleading and Practice, Ch. 536, *Subrogation* (Matthew Bender)
- . California Legal Forms--Transaction Guide, Ch. 25B, *Subordination, Assumption, and Assignment*, § 25B.31[1] (Matthew Bender)
- . California Legal Forms--Transaction Guide, Ch. 56, *Letters of Credit and Electronic Fund Transfers*, § 56.10 et seq. (Matthew Bender)
- . Matthew Bender Practice Guide: California Debt Collection and Enforcement of Judgments, Ch. 1, *Planning Collection of Debt*, 1.27, 1.35
- . Matthew Bender Practice Guide: California Debt Collection and Enforcement of Judgments, Ch. 9, *Planning Enforcement of Judgment*, 9.27

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67 of 79 DOCUMENTS

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Bernhardt on Heritage Oaks Partners v. First American Title Ins. Co.

2008 Emerging Issues 1381

Professor Roger Bernhardt on *Heritage Oaks Partners v. First American Title Ins. Co.*

By Roger Bernhardt

December 6, 2007

SUMMARY: The court found that (1) a subsequent purchaser was not entitled to recover its attorneys fees and damages on the theory that the title company caused the litigation by negligence (2) that no statutory authority imposed on an entity conducting a nonjudicial foreclosure sale of real property a duty of care to bidders at the sale and to all subsequent purchasers of the property to confirm that it was the trustee of record for the property.

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ARTICLE: *Heritage Oaks Partners v. First American Title Ins. Co.*, 155 Cal. App. 4th 339, 66 Cal. Rptr. 3d 510 (2007), is based on facts that are too complicated and rare to be helpful as direct authority for almost any proposition. But assuming that the holdings in it transcend the special circumstances of a substitution of trustee by reformation, there are two or three statements to give plaintiffs cause to worry and offer some comfort to counsel for foreclosure trustees.

Trustees Duties. The main holding -- that a trustees duties are limited to those specified in the deed of trust or enumerated in our foreclosure statutes -- is clearly protective of trustees. Those duties require a trustee merely to (1) prepare proper notices of default and sale and distribute them to the right parties, (2) sell the property at the right time and place, and (3) deliver the deed and sales proceeds to the parties entitled to them. Those duties do not include being the right trustee, or selling the right property, or even selling the right title to the property. If that limitation is taken literally, a trustee such as First American, who sold property that should have been sold by a different trustee, had no liability for its error, even without needing to claim a mutual mistake justifying reformation.

Under this rule, simple negligence theories will not often work, and parties who are unhappy with the sale are going to have to show something if they want to recover damages from the trustee. If the plaintiff is the purchaser or a successor (as opposed to the trustor or some other creditor), that something else cannot be the recitals in the trustees deed. A review of what it says in its recitals, or what the deed of trust says, or what Cal. Civ. Code § 2924 says it can say, does not impose any greater scope of duty on the trustee to be the right person or to sell the right land. The recitals in a trustees deed are not the equivalent of covenants of title or a right to convey implied in an ordinary grant deed in California under Cal. Civ. Code § 1113.

Foreseeability/Privity. Even when a plaintiff can get past the lack of duty barrier, he or she must deal with a second level of defense, labeled foreseeability, though it is really more of privity. The courts holding in *Heritage Oaks Partners*

that there is no reason to conclude that the foreclosure sale was intended by First American or Union Bank to affect anyone other than the parties to the deed of trust and the successful bidder at the sale [155 Cal. App. 4th at 346] imposes another serious hurdle for many potential plaintiffs.

As a practical matter, this may not always be a serious problem, since remote consensual market purchasers can be expected to make their offers conditional on title being marketable and to have title insurance policies doing the same, which thereby obviate the need for recovery against an unauthorized trustee (except for the title insurer who has paid and is then claiming subrogation rights). It is the immediate foreclosure purchaser, who is not able to make a conditional bid, and can hardly be expected to search out the authority of the trustees before entering the bidding, who is the party needing protection. In that case, if negligence can be shown and if there is no overriding reformation defense, there could be liability.

Cross References

. California Forms of Pleading and Practice, Ch. 555, *Trust Deeds and Real Property Mortgages* (Matthew Bender)

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Professor Roger Bernhardt on Salley v. Option One Mortgage Corp.

2008 Emerging Issues 1362

Professor Roger Bernhardt on Salley v. Option One Mortgage Corp.

By Roger Bernhardt

December 5, 2007

SUMMARY: In *Salley v. Option One Mortg. Corp.*, in which the PA Supreme Courts addressed the question of whether a residential mortgage loan arbitration agreement, which reserved judicial remedies related to foreclosure, was presumptively unconscionable. The state Supreme Court concluded that the exception from mandatory arbitration from foreclosure in the arbitration agreement did not, in and of itself, render that agreement presumptively unconscionable.

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ARTICLE: Background and Holding. *Salley v. Option One Mortgage Corp.*, 925 A.2d 115, 2007 Pa. LEXIS 1195 (Pa. 2007) settles one question in Pennsylvania, but does not do much more than that. The Pennsylvania Supreme Court answered only the narrow question certified to it by the Third Circuit Court of Appeals: whether an arbitration agreement, in a residential mortgage, was invalid because it exempted foreclosure and related remedies from its coverage. The Court's answer was even narrower than the question, holding that these exceptions did not make the agreement presumptively unconscionable under Pennsylvania law.

Implications Within Pennsylvania. This may mean that borrowers -- especially commercial ones -- are no longer likely to be able to mount successful attacks on the arbitration clauses contained in their mortgages, and that residential borrowers will be required to allege and prove considerably more in order to have their attacks considered by a court rather than by an arbitrator. The opinion also showed that Pennsylvania lenders need not revise the arbitration clauses in their mortgages merely to strengthen their validity.

On the other hand, lenders should be cautious in amending the clause for other purposes, lest those changes inadvertently weaken the immunity from judicial attack that the clause has now been given. There is too often a temptation by lenders to overreact with modifications to their forms in response to any recent setback one of them has encountered and to seek thereby to avert its recurrence in the future. The carveouts in this clause for judicial and nonjudicial foreclosures, setoffs, and rent collecting steps are undoubtedly the main concerns of Pennsylvania lenders and should be broadened only with extreme caution.

Implications Outside Pennsylvania. Outside of Pennsylvania, this decision merely adds another notch to one side

of the ongoing judicial debate over arbitration clauses that exclude foreclosure and its related features while including almost all borrower attacks. Their obvious adhesiveness and one-sidedness make them easy targets for consumer class actions. While the current balance of decisions seems to favor the clauses, even with their unbalanced carveouts, it is no tidal wave, and outcomes in many jurisdictions are yet to be known. Indeed, the first step that most practitioners should take, when deciding whether to make a challenge to the clause, is to learn what the rule is in their jurisdiction and -- if the question is unsettled -- what other jurisdictions may likely be influential.

Get Allies. Another important step is to get allies. Issues like this are of great concern to important interests in society. The borrower in this action was represented not only by counsel but also amicus briefs from the National Consumer Law Center, National Association of Consumer Advocates, and American Association of Retired Persons. The lender had behind it the American Bankers Association, American Financial Services Association, and the United States Chamber of Commerce. These groups can play important legal and financial roles in the litigation.

Seek Exemption from Federal Mandate. In light of the significant preemptive effect of the Federal Arbitration Act [9 USCS § 1 et seq.], it is unlikely that borrowers and consumer interest groups can get much assistance by turning to their own state legislators for assistance. Challengers will instead need to continue to seek exemption from the federal mandate, and corresponding access to judges, under the exclusion of "grounds at law or in equity for the revocation of any contract," which the federal act permits.

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69 of 79 DOCUMENTS

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Todd M. Grewe on Harris v. Suniga and Bunnell v. Construction

2008 Emerging Issues 1150

Todd M. Grewe on Harris v. Suniga and Bunnell v. Construction

By Todd M. Grewe

November 27, 2007

SUMMARY: Oregon law has been unclear on the limits of the Economic Loss Doctrine. Discussing both Suniga and Bunnell, Todd Grewe of Schwabe, Williamson & Wyatt offers insight as to how the impact of these cases serves to greatly diminish this doctrine and what one might consider in the wake of this new uncertainty.

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ARTICLE: Enhanced Owner Remedies:

A Diminution of Oregon's Economic Loss Doctrine Defense

Thanks to the Oregon Court of Appeals, Oregon's condominium, home and other building owners received an early holiday gift on December 6, 2006 and an early New Year's present on December 27, 2006. Due to these cases, non-original (or subsequent) building owners have a much improved chance to recover in negligence against original builders for faulty construction. The Economic Loss Doctrine (also known as the Economic Loss Rule) has been weakened as a defense against negligent construction claims in Oregon by the Oregon Court of Appeals rulings in *Harris v. Suniga, et al.*, 209 Or App 410, 149 P3d 224 (Dec. 6, 2006), n1 and its sister case, *Bunnell v. Dalton Construction*, 210 Or App 138, 149 P3d 1240 (Dec. 27, 2006). *Bunnell* enunciates some of the tacit reasoning and basis for the decision in *Harris*. As a result of these decisions, real estate professionals, sellers and builders must now consider and prepare for greater downside risk in their transactions.

The Economic Loss Doctrine Unclear. The Economic Loss Doctrine in Oregon, summarily, states that a would-be plaintiff has no recovery in negligence for economic losses in the absence of a special relationship between the litigants. A special relationship lacks a clear definition in Oregon, but is either contractual or regarded, through the development of case law, as a relationship in which the offending party owes a duty beyond the common law duty to exercise

reasonable care to prevent foreseeable harm. *Onita Pacific Corp v. Trustee of Bronson*, 315 Ore. 149, 159, 843 P.2d 890 (1992); see also *Hale v. Groce*, 304 Ore. 281, 744 P.2d 1289 (1987). When applied to construction defect cases, this Doctrine is used as a defense such that any building owner of used or non-original construction who is a subsequent buyer cannot recover damages sought under a negligence theory from the original builder for the intangible loss in value or economic loss of the structure due to damages caused by poor or negligent construction. A historically clear and consistent definition for economic loss has been elusive in Oregon, but focusing on the type of damage suffered is really the key to the use of the Economic Loss Doctrine as either a shield or a sword. The first clear definition of economic loss was articulated by the Oregon Supreme Court in *Onita Pacific Corp. v. Trustees of Bronson*, 315 Or 149, 159 n.6, 843 P2d 890 (1992), as financial losses such as indebtedness incurred and return of monies paid, as distinguished from damages for injury to person or property. Since *Onita*, economic losses have generally been referred to as financial losses due to intangibles. This is not a particularly clear definition, which explains why there has been so much litigation. But, if the damages suffered can be cast as being consistent with the meaning of property damage and non-economic loss, then the claimant can avoid the Economic Loss Doctrine and proceed in tort. *Harris and Bunnell* make it much easier to follow this course.

Action in Tort or Contract. A buyer wants to proceed in tort for construction defect, particularly because the potential recovery is higher. By contrast, under contract theory, recovery is only that which makes the claimant whole. That said, there has historically been tension between remedy in contract and remedy in tort as it relates to the Economic Loss Doctrine. The theory behind the Economic Loss Doctrine is that once a bargain has been struck and the contract terms are agreed upon, the buyer should no longer be able to circumvent the contract terms via tort.

When one suffers personal injury or other property damage from a defective product, the balance is in favor of tort. On the other hand, when solely economic loss is involved, the balance is in favor of the contract to control the parties disputesince only economic losses have been incurred, the parties contract [if there is one] understandably should govern their dispute. Interject negligence into the transaction and the Economic Loss Doctrine still provides that the party shall control their dispute over the economic losses. *The Fraud in the Inducement Exception to the Economic Loss Doctrine*, 90 Marq. L. Rev. 1921 (Summer, 2007), Ralph C. Anzivino.

This principal, if you will, is the law of Oregon, but it creates a problem if you are not the original owning party in contract privity with the builder and there are problems with your building. That is, unless you are the original owner, you would not have a contract with the builder and, therefore, cannot bring a breach of contract claim in the case of faulty construction.

The Impact of *Harris and Bunnell*. Prior to *Harris and Bunnell*, and as a continued matter of prudent practice, plaintiffs often cast their complaint in terms of property damage or bodily personal injury damage. In doing so, the claimant enhances his opportunities to trigger insurance coverage from which to get paid as well as to take the claim outside the realm of economic loss to allow for a tort negligence claim. But now, *Harris and Bunnell* help the subsequent building-owner by expanding the definition of property damage and, correspondingly, narrowing the scope of intangible economic loss and the application of the Economic Loss Doctrine.

In *Harris*, subsequent building-owners later discovered numerous construction defects after taking possession. Plaintiffs initiated a claim for negligent construction, which was dismissed on summary judgment after the defense argued the traditional tried and true defense that the plaintiffs negligence claim was barred by the Economic Loss Doctrine. Therein, plaintiffs had no claim for negligence barring a special relationship between the parties. The defense for the general contractor asserted no special relationship existed because the damages to the structure were deemed to be purely economic. The seminal issue before the appellate court was whether the plaintiffs negligence claim was barred by the Economic Loss Doctrine or, specifically, whether the harmed suffered was, in fact, economic loss. The Court ran through a history of the Economic Loss Doctrine in Oregon and, essentially, broadened the definition of property loss by narrowing the definition for economic loss.

The Economic Loss Doctrine Diminished. The *Harris* Court set out to determine whether the sort of economic losses that trigger that rule [Economic Loss Doctrine], because if their losses are not economic losses, then the limitation of the Economic Loss Doctrine do not apply. *Harris at 417-418*. Relying upon *Newman v. Tualatin Development Co., Inc.*, 287 Or 47, 597 P2d 800 (1979), the court determined that the deterioration of the physical structure of the buildings because of water damage was not economic loss. *Harris at 419-420 (internal cites omitted)*. This is a simple sentence, but the impact is huge because as it essentially dismantles the Economic Loss Doctrine as a defense in most construction defect cases. Pre-*Harris*, damages such as those suffered in *Harris* were typically defined as "economic loss" due to the vagueness of Oregon Construction law.

Bunnell adopts the expanded definition of property damage enunciated in *Harris*, but further adds to the mix in that even if a subsequent buyer knew of construction defects at the time of purchase and negotiated a commensurate decrease in the purchase price due to those defects, that buyer would still have suffered a loss recoverable in tort. The impact of these two decisions should not be lost on contractors, buyers or real estate professionals.

Practice Tips. These decisions not only enhance the possibility for tort recovery, but they also influence necessary knowledge needed by parties on all levels. Real estate professionals should now consider advising their selling clients on their increased potential liability. Conversely, the real estate professional should consider advising would-be subsequent purchasers of their enhanced legal rights. For their part, builders must now understand the implication that a downstream purchaser they do not know may have recourse against them at some future time. For this reason the builder may seek to insure away that risk, to the extent possible.

For further discussion regarding general principles and background of the economic loss doctrine, see Construction Law § 11.03 (LexisNexis).

For more information regarding breach of contract, see Construction Law § 11.02 (LexisNexis).

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n1 . This case is currently on appeal to the Oregon Supreme Court.

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He has earned both JD and MBA degrees from Syracuse University, and was a judicial extern clerk to U.S. District Court Judge Robert E. Jones. He is an active member of the American, Oregon, Washington, Colorado, and Multnomah Bar Associations, and was a Barrister with the American Inn of Courts. He is a frequent lecturer on construction and

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70 of 79 DOCUMENTS

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Kellman on the Uses of the Retaliation Doctrine in Unlawful Detainer Actions

2008 Emerging Issues 1043

Steven R. Kellman on the Uses of the Retaliation Doctrine in Unlawful Detainer Actions

By Steven R. Kellman

November 19, 2007

SUMMARY: In CA landlord-tenant relations, use of the doctrine of retaliatory eviction by a tenant is a complex, often misunderstood legal approach. The retaliation doctrine was born of common law's attempt to protect a tenant from the effects of a vengeful landlord. Although the retaliation doctrine is mostly codified [see, e.g., Civ. Code § 1942.5], a careful reading of the statutes may not reveal the true application and limitations of the doctrine.

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ARTICLE: Introduction to Retaliation. In the arena of California landlord-tenant relations, use of the doctrine of retaliation by a tenant is a complex, often misunderstood legal approach. Retaliation is both a defense to certain landlord actions and a basis of a tenant's affirmative claims. The retaliation doctrine was born of common law's attempt to protect a tenant from the effects of a vengeful landlord. Relief available under the doctrine can be both injunctive and monetary. Although the retaliation doctrine is mostly codified [see, e.g., Civ. Code § 1942.5], a careful reading of the statutes may not reveal the true application and limitations of the doctrine. The careful practitioner will enter this practice area only with the understanding and tools necessary to avoid the traps and pitfalls awaiting the unwary.

Retaliation Doctrine's Basis in Law. Retaliation against tenants in residential tenancies has long been disfavored by the law. Landlords historically have had the power to suppress tenants' assertion of rights by threats of punitive action including eviction, increased rent, and decreased services. Tenants are often afraid to complain or take action against landlords for fear of retribution. This threat has a chilling effect on many tenants, who keep silent and endure unsafe and abusive living conditions rather than asserting their rights and thereby risk suffering the vengeance of the landlord.

Retaliation case law evolved over time, resulting in legislative action to protect tenants, in the enactment *Civil Code Section 1942.5* [see, e.g., *S.P. Growers Ass'n v. Rodriguez* (1976) 17 Cal. 3d 719, 723, 131 Cal. Rptr. 761, 552 P.2d 721; *Vargas v. Mun. Ct. (McAnally Enterprises, Inc.)* (1978) 22 Cal. 3d 902, 916, 150 Cal. Rptr. 918, 587 P.2d 714; see also *Barela v. Super. Ct. (Valdez)* (1981) 30 Cal. 3d 244, 249, 178 Cal. Rptr. 618, 636 P.2d 582; *Rich v. Schwab* (1998) 63 Cal. App. 4th 803, 810, 75 Cal. Rptr. 2d 170]. These cases illustrate the evolution and application of this doctrine to *Civil Code Section 1942.5*. Retaliation is also prohibited by *Government Code Section 12955(f)*.

Provisions of Civil Code Section 1942.5. The rights in *Civil Code Section 1942.5* are broken into two main parts. First, Section 1942.5(a) provides a bar to residential eviction, increase in rent, or decrease in services within 180 days of the tenant's protected acts of the tenant. Protected acts are covered in Section 1942.5(a)(1)-(5). A tenant may use this subdivision only once in a 12-month period [*Civ. Code § 1942.5(b)*]. The second part, Section 1942.5(c), provides more general protection for both residential and commercial tenancies, proscribing retaliation against a tenant who has "lawfully organized or participated in a lessees' association or an organization advocating lessees' rights or has lawfully and peaceably exercised any rights under the law" [*Civ. Code § 1942.5(c)*]. The rights granted in Section 1942.5 are generally nonwaivable [*Civ. Code § 1942.5(d)*].

There is an exemption to the remedies for a tenant found in Subsections (a) and (c), such as recovering possession, if the landlord "states the ground upon which the lessor, in good faith, seeks to recover possession, increase rent, or do any of the other acts described in subdivision (a) or (c)" [*Civ. Code § 1942.5(e)*].

There are penalties against a landlord for violating Section 1942.5 including actual damages, attorney's fees (if requested at the inception of the case), and punitive damages between \$100 and \$2,000 for each retaliatory act, if the landlord was guilty of fraud, oppression, or malice [*Civ. Code § 1942.5(f), (g)*].

Provisions of Government Code Section 12955. *Government Code Section 12955* proscribes various housing discrimination and adds a component of retaliation in Section 12955(f), which makes retaliation unlawful when the "dominant purpose is retaliation against a person who has opposed practices unlawful under this section." Although this lends support to an affirmative claim, it is not intended to delay an eviction. "Nothing herein is intended to cause or permit the delay of an unlawful detainer action" [*Gov. Code § 12955(f)*].

Application of Retaliation Doctrine in Unlawful Detainer. The most common use of a claim of retaliation is as a defendant's (the tenant) affirmative defense to a plaintiff's (the landlord) unlawful detainer action. Although most common in residential cases, a retaliation defense can also be supported in commercial cases [*see Custom Parking v Sup. Ct. (1982) 138 Cal. App. 3d 90, 93, 187 Cal. Rptr. 674*].

To effectively defend an unlawful detainer action with a retaliation defense, the tenant must raise the defense within the time for filing a response. This is most easily accomplished by alleging retaliation as an affirmative defense in the answer. The tenant may also raise this issue by motion, such as summary judgment, or by demurrer. However, these methods are not favored by courts, because retaliation is usually a question of fact to be determined by a trial court.

Tread carefully here, because the retaliation waters become murky. The notices that lend themselves to a retaliation defense are the 30- or 60-day termination of tenancy notices in periodic tenancies. Defending against a three-day notice to pay or quit is unavailable under *Civil Code Section 1942.5(a)* because the tenant must not be "in default as to the payment of his rent" [*Civ. Code § 1942.5(a)*]. Of course, if a tenant can prove that he or she was not in default, even though rent was unpaid, it is arguable that this can be raised [*see EDC Assoc. v. Gutierrez (1984) 153 Cal. App. 3d 167, 174, 200 Cal. Rptr. 333 (Andreen, J., concurring)*].

Because retaliation is an affirmative defense, the tenant must raise it in the answer or face the possibility of its use being precluded at trial. Of course, the tenant may file an amended answer before trial if the retaliation defense later becomes apparent. Further, the answer can be amended at or before trial, with leave of court, if it becomes clear that the defense is applicable. On motion to the court, especially during trial, the tenant should point out that a plaintiff may amend the complaint during trial if the facts warrant [*Code Civ. Proc. § 1173*], so basic fairness would allow a similar amendment for the defendant (tenant).

Proving the Defense in an Unlawful Detainer Trial. The defendant (tenant) must first have alleged retaliation as an affirmative defense in the answer with supporting facts. Merely checking the box on the Judicial Council answer form for retaliation may not be sufficient and could be stricken by the plaintiff (landlord) by motion at trial [*Code Civ. Proc. § 436*]. Pleading retaliation is one thing, proving it is another.

Proving a Case in Retaliation. Through common law derivations and codification, the basis of the retaliation defense is the unlawful motive or intent of the landlord (the plaintiff) in taking the action complained of. "From our review of the history surrounding *Civil Code section 1942.5*, we conclude that in enacting the latest version of the statute the Legislature did not intend to alter the common law rule regarding the burden of proving retaliatory motive" [*Western Land Office, Inc. v. Cervantes* (1985) 175 Cal. App.3d 724, 742, 220 Cal. Rptr. 722].

Proving motive is difficult because the landlord will rarely admit an illegal intent. Proof will be from various types of evidence including direct, indirect, inferential, extrinsic, and other forms of evidence to show the landlord's true motive. The defendant (tenant) initially bears the burden of proof, by a preponderance of evidence, that the landlord has acted in unlawful retaliation in serving the eviction notice. "To sum up: In an unlawful detainer action, where the defense of retaliatory eviction is asserted pursuant to *Civil Code section 1942.5*, the tenant has the overall burden of proving his landlord's retaliatory motive by a preponderance of the evidence" [*Western Land Office, Inc. v. Cervantes* (1985) 175 Cal. App. 3d 724, 742, 220 Cal. Rptr. 722].

Proof of retaliation can be as simple as a declaration of vengeance or as complex as can be imagined. *Civil Code Section 1942.5(a)* allows a retaliation claim for an eviction in response to many enumerated acts, including these:

- (1) After an oral complaint to the landlord regarding tenantability.
- (2) After a written or oral complaint which with an appropriate agency, of which the landlord has notice, to obtain correction of a condition relating to tenantability.
- (3) After an inspection or issuance of a citation, resulting from a complaint described in (2) of which the landlord did not have notice.
- (4) After filing appropriate documents commencing a judicial or arbitration proceeding involving the issue of tenantability.
- (5) After entry of judgment or signing an arbitration award, if any, when in the proceeding or arbitration the issue of tenantability was determined adverse to the landlord.

Besides these enumerated instances, Section 1942.5(c) provides broad protections against causing a tenant to quit involuntarily, bringing an action to recover possession, or threatening these for the purpose of retaliating against the tenant for lawfully organizing or participating in a lessees' association or organization advocating lessees' rights, or lawfully and peaceably exercising any rights under the law [*Civ. Code § 1942.5(c)*].

This allows a tenant a variety of grounds for the basis of a retaliatory connection in defending against a notice to quit. Further, there are additional avenues to claim retaliation by using the prohibitions against rent increases or the decrease in services as a defense to an eviction [*see Civ. Code § 1942.5(c)*]. In these cases, for example, the tenant can claim the nonpayment was not a default in the payment of rent, if the increased rent was due to an illegally increased rent. In this case, the tenant would not be in "default" of the payment of rent, because a retaliatory rent increase could void the rent claimed due. The tenant could also claim that the nonpayment of a service (e.g., utility charge) in a three-day notice to cure or quit was not improper if the charge was connected to an illegally decreased service.

Proving motive usually requires a connection between the protected action of tenant and the retaliatory eviction reaction of the landlord. If the tenant claims the retaliatory grounds arise from Section 1942.5(a), there is a 180-day window for the action-reaction in the proof. Under Section 1942.5(c), there is no such window. Many tenants are misled by the code to believe that a complaint or other protected act from Section 1942.5(a) protects them for 180 days against retaliation. This is not true. In reality, the courts need to see an action-reaction more closely in time than 180 days for both subsections. Many things can happen in that time that can intervene to supersede a retaliation claim.

Meeting Tenant's Burden of Proof. To make the case for retaliation, the tenant must prove by a preponderance of

the evidence that the eviction notice, or threat of eviction, was in retaliation for a protected act. The tenant must produce evidence of retaliation, which can be through the landlord's presentation of its case. Certain acts are regarded as so suspect as to create an inference or presumption of retaliation. For example, a landlord may prove a 30-day notice was served. On cross examination, the landlord may admit that one week before the 30-day notice, the landlord received a written complaint about the habitability of the dwelling. With no other refuting evidence, the court will probably find retaliation occurred. The tenant can, in its case, effectively do the same and meet the initial burden. This is where careful attention is required, since meeting the initial burden of proving an unlawful retaliation is only the beginning. Unless care is taken after this point, a tenant can watch this victory evaporate as the landlord takes it away.

Shifting Burden of Proof to Landlord. After the tenant has proved an initial claim in retaliation, the landlord has the opportunity to refute that claim, thus voiding the defense entirely. Once retaliation has been proved, the landlord can do any one of the following:

- (1) Refute the claim by alleging the motive was not retaliatory despite the connection evidence.
- (2) Refute the evidence and claim it has no weight.
- (3) Allege certain legal bars to retaliation.
- (4) Allege good cause to evict existed.

Refuting and rebutting the evidence is a case-by-case situational analysis that essentially claims the tenant's evidence was not sufficient or, if it was credible admissible evidence, did not prove what tenant claimed it proves.

There are certain bars to the use the retaliation defense. Nothing limits the exercise by the landlord of rights under any lease or agreement or any law pertaining to the hiring of property or the right to do any of the acts described in Section 1942.5(a) or (c) for any lawful cause [*Civ. Code* § 1942.5(d), (e)]. This allows exceptions to retaliation claims for specified rights of the landlord in the lease or, for example, in the application of the Ellis Act [*see Gov. Code* § 7060 et seq.], including taking a unit off the market. "We therefore agree with Landlord that section 1942.5, subdivision (d), constitutes an exception to the limitations on landlord conduct set forth in subdivisions (a) and (c)" [*Drouet v. Superior Court* (2003) 31 Cal. 4th 583, 595, 3 Cal. Rptr. 3d 205, 73 P.3d 1185]. Any waiver by a tenant of rights under Section 1942.5 is void as contrary to public policy [*Civ. Code* § 1942.5(f)].

Civil Code Section 1942.5(e) allows a landlord to act with retaliation in mind as long as he or she has a good faith reason to evict and states that reason in the notice. In the use of Section 1942.5(e), a landlord can issue an eviction notice when the facts would raise the issue of retaliation, but the landlord wants to make it clear that he or she had a valid, dominant reason to evict. By this method, the landlord puts the good faith reason in the notice, which essentially creates a good cause requirement when it would not otherwise have been required on the notice. Of course, the landlord must then prove the existence, validity, and good faith of the cause alleged in the notice. If the landlord successfully refutes or rebuts the tenant's evidence, or the landlord successfully proves an applicable bar or exception to the retaliation claim made, the burden shifts back to the tenant.

Shifting Burden of Proof Back to Tenant. The tenant has now made an initial prima facie case in retaliation. The landlord has, by one or more of the above methods, rebutted, refuted, or demonstrated a legal bar to the use of the retaliation defense. Unless the tenant acts decisively at this point, the defense is lost.

The tenant has a final opportunity to show that the landlord's claim is without merit. For example, the tenant may show that the "good faith" reason in the notice was a pretext, fabricated to cover the true retaliatory motive.

Judgment if Tenant Prevails. Judgment is entered in the tenant's favor if the tenant prevails in the unlawful

detainer action. This restores the tenancy, and the tenant is considered the prevailing party for a motion for attorney's fees [*see Civ. Code § 1717*]. Because the tenant has successfully used the retaliation defense, the landlord risks facing another retaliation claim if he or she tries to evict within 180 days, unless the landlord can use one of the exceptions allowing eviction. However, recall that the retaliation defense can be raised only once in any 12-month period [*Civ. Code § 1942.5(a)*]. Section 1942.5(c) has no such restriction. In this instance, an affirmative award of damages cannot be obtained, because this is strictly a defensive use of the retaliation doctrine. Cross complaints are generally not permitted in unlawful detainer actions [*Medford v. Superior Court (1983) 140 Cal. App. 3d 236, 239, 189 Cal. Rptr. 227*].

Affirmative Claims for Retaliation. Retaliation can be used as a sword as well as a shield. Under both *Government Code Section 12955* and *Civil Code Section 1942.5*, a tenant, whether involved in an eviction or not, can now be a plaintiff suing for improper retaliation. *Government Code Section 12955* allows for a claim due to retaliation, which sounds more in discrimination. This is typically used when a landlord has retaliated against a tenant for asserting the right to be free from discriminatory practices. There is no cap to damages in an action brought under Section 12955.

In an unlawful detainer eviction proceeding, a tenant who prevailed under *Civil Code Section 1942.5* can now file a separate suit for damages for the attempted eviction. Section 1942.5 allows the award of actual damages and punitive damages of \$100 to \$2,000 to a plaintiff tenant for each retaliatory act, if the landlord or agent was guilty of fraud, oppression, or malice. The tenant can also recover reasonable attorney's fees if either party requests attorney's fees on the initiation of the action [*Civ. Code § 1942.5(f), (g)*]. The tenant is not limited to punitive damages, which can be difficult to prove. Section 1942.5(h) provides that these are not exclusive remedies.

Therefore, a judgment of landlord retaliation in an eviction proceeding can open the door to a followup claim by a tenant for affirmative damages. The tenant is not limited to the punitive damages cap of \$2,000, but is limited to actual damages or other remedies allowed by law for each retaliatory act.

Conclusion. The law disfavors suppressive acts by landlords motivated by vengeance against tenants for assertion of tenant's rights. The law seeks to protect residential tenants, generally in a weaker social and bargaining position than landlords. However, courts tend to disfavor retaliation as a defense, because it is easily alleged and difficult to prove. It is fraught with complexities, such as shifting burdens of proof and a confusing array of exceptions and defenses to the exceptions. Because unlawful detainer is a summary proceeding, complete litigation of a case in which this defense is raised strains trial courts, which are mandated to handle unlawful detainers expeditiously.

Retaliation as a motive for punitive landlord action against a tenant is wrongful and should be prevented. The main issue to determine is whether the landlord action was indeed unlawfully retaliatory, and whether there is an exception to the action that bars the claim.

For further discussion of retaliation as a defense, *see* Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 5, *Unlawful Detainer*, 5.21, and California Forms of Pleading and Practice, Ch. 333, *Landlord and Tenant: Eviction Actions*, § 333.28 (Matthew Bender).

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Steven R. Kellman has practiced landlord-tenant law since 1982 with an emphasis on representing residential and commercial tenants. In 1993, he founded the Tenants Legal Center in San Diego. Mr. Kellman has lectured for professional and educational institutions including the University of San Diego School of Law, Continuing Education of

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71 of 79 DOCUMENTS

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Jaworski on Subprime: Final Guidance

2008 Emerging Issues 862

Jaworski on Subprime: Final Guidance

By Robert M. Jaworski

November 5, 2007

SUMMARY: In his analysis of the Final Guidance on Subprime Mortgage Lending issued by federal bank regulators on June 29, 2007, mortgage compliance expert Robert M. Jaworski, Esq., answers such important questions as * to whom does the guidance apply?* to what loans does the final guidance apply?* what are ""subprime loans""?* what specific types of subprime loans are the agencies most concerned about in the final guidance?* should banks worry that the final guidance will be applied in the context of prime loans?* do non-bank lenders need to be concerned about the guidance?* do the agencies consider such loans to be ""predatory""?* what standards must banks use when underwriting subprime loans?* what is the appropriate interest rate to use when underwriting a subprime arm loan?* can banks still make ""stated income"" loans?* must banks now perform a ""suitability"" analysis before making a subprime loan?* under what circumstances may banks enter into workout arrangements with their subprime borrowers?* what about prepayment penalty periods/must they be limited?* are banks going to have to make more consumer disclosures?* are there prescribed forms that must/may be used for this purpose?* what kind of information must be disclosed?* will banks need to have controls to ensure compliance?* is this guidance a good thing?"

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ARTICLE: On November 16, 2007, the U.S. House of Representatives, by a vote of 291 to 127 passed H.R. 3915, titled *The Mortgage Reform and Anti-Predatory Lending Act of 2007* (the Bill). The Bill is aimed at preventing a repeat of the problems associated with the subprime crisis, and it takes a scattershot approach, blasting various industry participants and practices in the process. If the Senate goes along with the Bill in its present form, which is unlikely, the Bill would, at the very least, dramatically alter the residential mortgage loan origination landscape.

The most critical sections of the Bill would: (1) impose minimum licensing or registration requirements upon all residential mortgage loan originators; and (2) amend the Truth-in-Lending Act (TILA) to (a) impose minimum loan origination standards upon mortgage loan originators, (b) prescribe minimum standards and require additional disclosures in connection with residential mortgage loans, and (c) expand and toughen rules relating to loans covered by the Home Ownership and Equity Protection Act (HOEPA). Highlights of these sections are set forth below.

Additionally, the Bill would (1) establish a federal Office of Housing Counseling to create and administer counseling programs relating to housing, homeownership, mortgages and rental housing; (2) require additional items of information to be disclosed to consumers as part of the good faith estimates mandated by the Real Estate Settlement

Procedures Act (RESPA); (3) revise RESPA rules applicable to servicers (to mandate the establishment of escrow accounts in connection with certain loans and require servicers to satisfy certain conditions before they can force-place insurance); (4) require creditors to provide copies of appraisals to all HOEPA-loan borrowers prior to closing and prohibit any person with an interest in a loan from attempting to coerce, extort, induce, bribe or intimidate an appraiser's judgment as to the value of a property for purposes of qualifying for a mortgage loan; and (5) appropriate money to the Department of Justice for use in combating fraud.

Minimum Mortgage Originator Licensing/Registration; National Registry

The Bill prohibits any person from engaging in the business of a mortgage originator without being registered with their principal federal bank regulator or licensed by the state or states in which he/she will do business. The Bill defines mortgage originators essentially as persons who, for compensation or in the expectation of compensation, take applications for, assist consumers in obtaining or applying for, or offer or negotiate terms of, residential mortgage loans (Originators). Purely administrative or clerical personnel are not Originators.

The Bill also requires states to have in place, within a year (or two) of its enactment, Originator licensing laws that require evidence of good character, pre-licensing and continuing education, and testing, and that empower a state supervisory authority (the State Regulator) to supervise and take enforcement action against them for violations. If they do not, then a back-up federal licensing system administered by HUD will take its place.

The Bill also establishes a Nationwide Mortgage Licensing System and Registry (the Registry) in which information concerning Originators will be collected and maintained

TILA Amendments

New Section 129A

Duty of Care. New TILA section 129A imposes upon all Originators a duty of care. This duty requires Originators, among other things, to present consumers with a range of appropriate loan products for which they can qualify, and fully disclose to consumers the comparative costs and benefits of each such loan product, the cost of the Originators services, whether the Originator is or is not acting as the consumers agent, and any relevant conflicts of interest. The Bill, however, does not create an agency or fiduciary relationship between Originators and their customers.

Steering. New Section 129A also prohibits Originators from receiving incentive compensation (including yield spread premiums) that is based on or varies with the terms of the loan (other than the amount of principal), unless the loan is a qualified mortgage. Originators also may not steer a consumer to a loan that (a) the consumer does not have a reasonable ability to repay, (b) that refinances a prior loan but does not provide the consumer with a net tangible benefit, (c) has predatory characteristics or effects, or (d) is not a qualified mortgage when the consumer in fact qualifies for such a mortgage. And Originators are not permitted to engage in abusive or unfair practices that promote disparities based on race, ethnicity, gender or age.

Qualified mortgages include FHA/VA loans and dwelling-secured loans which have an annual percentage rate (APR) that is (a) less than the comparable Treasury yield + 3%, for a first-lien loan, or 5%, for a junior-lien loan, or (b) less than the conventional mortgage rate + 1.75%, for a first-lien loan, or 3.75% for a junior-lien loan.

New Section 129B

Ability to Repay/Tangible Net Benefit. New TILA section 129B imposes two primary requirements upon creditors making residential mortgage loans (closed-end loans secured by a dwelling that are not reverse mortgages): first, that the borrower have the ability to repay the loan and all taxes, assessments and insurance premiums; and, second, that a refinance loan provide the borrower with a tangible net benefit (to be defined by regulation). Ability to repay must be verified and documented by the creditor and, with respect to an ARM loan that allows for non-amortizing payments, be based on a fully amortizing payment schedule using the fully-indexed rate and with no balloon payment. Also, no tangible net benefit will be deemed to exist if the cost of the refinance loan exceeds the amount of any newly advanced principal without any corresponding changes in the terms of the loan.

Safe Harbors/Presumptions. Qualified mortgages and qualified safe harbor mortgages are presumed to fulfill both of these requirements, and this presumption may only be rebutted in the case of a qualified safe harbor mortgage and, even then, only *as to the creditor* (not as to assignees or securitizers, unless the creditor no longer exists or has filed for bankruptcy). Qualified safe harbor mortgages are full documentation loans that (1) are underwritten using the fully-indexed rate taking into account all applicable taxes, insurance and assessments, (2) do not provide for repayment schedules that result in negative amortization, (3) meet other requirements established by regulation; and (4) have fixed monthly payments for at least the first 5 years of the loan term, are ARM loans with margins less than 3%, or have debt-to-income ratios below a maximum percentage to be established by regulation.

Right of Rescission for Violations. The Bill allows loans made in violation of either of these requirements to be rescinded by a court, unless the violation is cured within 90 days after closing and before receipt of notification of the violation from the consumer. Assignees and securitizers can also avoid liability under these provisions essentially by proving that their purchase of a loan that was neither a qualified mortgage nor a qualified safe harbor mortgage was unintentional and occurred despite reasonable policies and procedures designed to prevent it.

Other Violations. The Bill prohibits prepayment penalties on residential mortgage loans that are not qualified mortgages. It also limits prepayment penalties on qualified mortgages in the following regards: (1) they may not be charged unless the borrower is offered a loan that does not carry a prepayment penalty; (2) the prepayment penalty may not exceed 3%, 2% and 1% of the outstanding loan balance, respectively, during the 1st, 2nd and 3rd years after closing; and (3) if the loan has a teaser rate, the prepayment penalty may not extend beyond 3 months before the teaser rate is scheduled to reset. In addition, the Bill prohibits (1) the financing of single premium credit insurance, (2) mandatory arbitration clauses, and (3) negative amortization features absent prescribed disclosures and, with respect to first-time borrowers of non-qualified mortgages, mandatory homeownership counseling.

Preemption. The Bill preempts state laws that provide additional remedies against assignees (or securitizers) for violations of the ability to repay or net tangible benefit requirements or which address these specific subject matters.

Statutory Damages/Statute of Limitations. The Bill also (1) doubles the minimum and maximum penalties that attach to TILA violations generally, (2) extends the time within which claims of such violations may be asserted from 1 year to 3 years, and (3) states that creditors, assignees and securitizers are not liable for damages or rescission if the borrower, to qualify for the loan, knowingly and willfully provided them with material information that was not true.

New Section 128A and Amendment to Section 12

New TILA Section 128A requires creditors, assignees or servicers to send reset notices containing specified items of information to borrowers of hybrid ARM loans. A hybrid ARM loan is a loan the interest rate of which is fixed for an introductory period and then resets to a variable rate. Reset notices must be sent between 6 and 7 months prior to the interest rate reset date.

The Bill also enhances in various respects TILA disclosure requirements applicable to closed-end mortgage loans and requires that lenders, assignees or servicers provide borrowers with a monthly disclosure statement to be developed by regulation of the Federal Reserve Board.

Amendments to HOEPA Rules

The Bill also amends the TILA provisions that apply to HOEPA loans (dubbed high-cost loans under the Bill). It: (1) expands the definition of a HOEPA loan to include purchase money loans, open-end loans and loans with prepayment penalties that are payable more than 36 months after the loan closing or that can exceed more than 2% of the amount prepaid; (2) conforms the HOEPA APR trigger in TILA to the current APR trigger in Regulation Z; (3) reduces the HOEPA points and fees threshold from 8% to 5% of the total loan amount; and (4) expands the definition of points and fees to include additional items (indirect compensation paid to a mortgage broker [*e.g.*, yield spread premiums], premiums for credit insurance or debt cancellation benefits, the maximum prepayment penalty that the borrower may have to pay on the loan [unless it is a conventional prepayment penalty], and any prepayment penalty that the borrower may have to pay on a loan that he/she is refinancing with the same creditor or an affiliate). The Bill permits 1 or 2 points (depending on the loan interest rate) to be excluded from points and fees provided they qualify as bona fide discount points.

The Bill also prohibits in connection with HOEPA loans: (1) balloon payments (even after 5 years); (2) making a HOEPA loan without reasonably believing at the time the loan is made that the borrower will be able to repay it or without requiring pre-loan credit counseling; (3) charging late fees in excess of 4% of the amount of the past due payment or less than 15 days after the payment due date; (4) including call provisions; (5) financing points and fees; (6) financing prepayment penalties paid in connection with a loan being refinanced by the same creditor or an affiliate; (7) structuring a loan as an open-end loan or dividing it into separate parts with the intent to evade HOEPA; (8) charging fees to modify the terms of a loan or to allow for the deferral of payments; (9) charging payoff quote fees or providing payoff quotes more than 5 business days after receiving the request; and (10) flipping (refinancing a borrowers loan without providing the borrower with a reasonable tangible net benefit under all the circumstances).

Summary

As is evident from the above summary, the changes which the Bill would make to the regulatory scheme under which mortgage originators operate and under which home mortgage loans are made, sold and securitized are numerous and substantial. The question that the U.S. Senate must now wrestle with is whether these changes will ultimately be to the public good or will result in unintended consequences that will prove more damaging to the economy and to borrowers in general than the harm it is intended to prevent. The Senate might perhaps consider whether a rifle, rather than a shotgun, would be a better legislative weapon to deal with this problem. The one sure thing about the Bill, however, is that it should keep lobbyists very busy over the next several months.

ABOUT THE AUTHOR(S):

Robert M. Jaworski is a partner in the Financial Services Regulatory Group of Reed Smith, LLP in Princeton, New Jersey and a former Deputy Commissioner of the New Jersey Department of Banking. He is also Co-Chair of the RESPA and Housing Finance Subcommittee of the American Bar Associations Consumer Financial Services Committee; the former Editor of *Pratts Mortgage Compliance* letter, a national publication on mortgage compliance issues; and the Secretary of the Board of Directors of the New Jersey Bar Associations Banking Law Section. Mr. Jaworski provides federal and state compliance and regulatory advice to banks, mortgage lenders and other consumer financial services providers, and regularly assists Reed Smith litigators in defending financial institutions in individual and class actions. He has written on real estate topics for several LexisNexis publications, including *Real Estate Financing* (LexisNexis Matthew Bender), which features his Special Alert on State Governmental Responses to Problems in the Subprime Mortgage Loan Origination Business.



72 of 79 DOCUMENTS

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Michael Allan Wolf on Mendota Golf v. City of Mendota Heights

2008 Emerging Issues 861

Michael Allan Wolf on Mendota Golf v. City of Mendota Heights

By Michael Allan Wolf

November 5, 2007

SUMMARY: In *Mendota Golf, LLP v. City of Mendota Heights*, the Minnesota Supreme Court affirmed the supremacy of the comprehensive plan over zoning ordinances and addressed important issues regarding the level of judicial scrutiny appropriate for evaluating the validity of zoning decisions and the appropriate remedies for correcting alleged missteps by local government officials.

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ARTICLE: Minnesota Supreme Court Addresses Problem of Reconciling Conflicts Between Zoning Ordinance and Comprehensive Plan

Four important land use law trends converge in this 2006 case decided by the Supreme Court of Minnesota-the requirement that zoning classifications conform to the comprehensive plan, the conversion of golf courses to residential and commercial uses, the preservation of open space, and the regional approach to planning. In the process of resolving the discrete dispute facing the court, the justices addressed important issues regarding the level of judicial scrutiny appropriate for evaluating the validity of zoning decisions and the appropriate remedies for correcting alleged missteps by local government officials. The result is an important and well-reasoned decision that provides guidance to state and federal courts who will continue to wrestle with these issues and trends in the years to come.

Plan Supremacy. The majority decision in *Mendota Golf* affirms the supremacy of the comprehensive plan, a position supported by a change that Minnesota lawmakers made in 1995 to the state's Metropolitan Land Planning Act, a statute that is applicable in all or part of seven counties in the Twin Cities region. For decades, judges have wrestled with the implications of the oft-stated proposition-which can be traced back to the Standard State Zoning Enabling Act of the 1920s-that zoning regulation must be "in accordance with a comprehensive plan." A growing number of states, dissatisfied with the failure of local governments to take the initiative to enact such a plan as a document distinct from the zoning ordinance or map, have, like Minnesota, imposed a statutory requirement on some or all of the jurisdiction's municipalities. Moreover, whereas before the 1995 change, "a city's zoning designations took priority over conflicting comprehensive plan designations," *Mendota Golf*, 708 N.W.2d at 166, the amended statute effected a significant shift in favor of plan supremacy by "provid[ing] that the comprehensive plan constitutes the primary land use control for cities

and supersedes all other municipal regulations when these regulations are in conflict with the plan," *Mendota Golf*, 708 N.W.2d at 175 (citing Minn. Stat. § 473.858, subd. 1). *Mendota Golf* demonstrates that the consistency problem is not necessarily solved by a simple statutory mandate. Local officials, supervised by generally deferential courts, still must ensure that, on the one hand, their zoning decisions do not defeat the goals of the comprehensive plan, and that, on the other hand, the plan is regularly updated to reflect changes on the ground.

From Fairways to Driveways. Over the last decade, as the pace of conversions has accelerated dramatically, courts throughout the country have been asked to resolve legal puzzles posed by efforts of golf course owners to intensify the use of their property to residential or commercial uses (or a combination of the two). In addition to *Mendota Golf*, representative cases include *Golf Club of Plantation, Inc. v. City of Plantation*, 847 So. 2d 1028 (Fla. Ct. App. 2003) (noting that the city had made clear its policy of banning golf course conversions), *In re Realeen Valley Forge Greenes Assocs.*, 576 Pa. 115, 838 A.2d 718 (2003) (successfully challenging the agricultural zoning designation of golf course as an example of reverse spot zoning), *A&F Props., LLC v. Madison County Bd. of Supervisors*, 933 So. 2d 296 (Miss. 2006) (enforcing a contract provision to maintain a golf course for ten years), and *Upland Hills Country Club Condo. Ass'n v. Upland Development, LLC*, 2006 Cal. App. Unpub. LEXIS 2122 (Mar. 14, 2006) (limiting the scope of an easement granting "use and enjoyment over the Golf Course"). In conversion situations, important questions of private and public law converge, as attorneys and judges struggle with difficult issues such as implied servitudes, downzonings, and regulatory takings. In fact, the dissenters in *Mendota Golf* suspected that, by requiring the landowner to maintain the recreational uses of the property and thus to forego the expected profits from creating a residential subdivision, the city might well have effected a regulatory taking. As it turns out, the city amended the comprehensive plan in December 2006, to allow for the development of a smaller subdivision, then decided to allow the voters to decide whether they instead wanted Mendota Heights to purchase (and thereby preserve) the golf course.

Preserving Open Space. In highly developed urban and suburban areas, open space is at a premium. Various strategies are being employed to preserve this dwindling public amenity, including exactions from developers seeking to make more intensive use of land and expenditures of public money to purchase undeveloped parcels in fee or conservation easements restricting use. *Mendota Golf* illustrates the difficulties localities face when they attempt to preserve open space by shifting the burden to private landowners who, before development pressures and a downturn in the golf industry made conversion hard to resist, reaped a benefit from the recreational use of their lands while furnishing scenic vistas and wildlife habitats that also benefit the general public. Are there valid bases for distinguishing the situation faced by the owner of a big-box store that cannot compete anymore in the retail market from the golf course owner whose bottom line is shrinking? If, in the first case, we have no legal or constitutional qualms about refusing to rezone the store parcel to a more intensive use, why should we treat the golf course owner differently? In other words, does the golf course owner have a legally protected right to make what is now the highest and best use of the property, even after neighborhoods and expectations have grown up next to and around the facility?

Regionalism in Action. *Mendota Golf* is also notable as an example of the regional approach to land use planning. The court's statutory analysis focuses on a key provision of state law mandating comprehensive and coordinated planning. Minnesota lawmakers have recognized that "the local governmental units within the metropolitan area are interdependent" and that, "[s]ince problems of urbanization and development transcend local governmental boundaries, there is a need for the adoption of coordinated plans, programs and controls by all local governmental units and school districts in order to protect the health, safety and welfare of the residents of the metropolitan area and to ensure coordinated, orderly and economic development." Minn. Stat. § 473.851. The direct impacts of this statutory scheme on the conflict in *Mendota Golf* are the city's duty to coordinate zoning and the comprehensive plan and its obligation to submit any plan amendments to the Metropolitan Council. This extra layer of regulation and oversight, designed to minimize extra-boundary spillovers and increase the coordination of planning decisionmaking, can also have the added benefit of protecting landowners and neighbors from local government abuses.

Mandamus and the Need for Rationality. One of the most valuable contributions made by the court in *Mendota Golf* is its discussion of the various remedies available to parties frustrated by planning and zoning decisions made by local officials. While emphasizing that mandamus is an extraordinary remedy, the justices still remand the case to the

trial level so that a writ can be issued, not necessarily to direct the city to change the comprehensive plan along the lines suggested by the landowner. Instead, city officials are encouraged to explore alternative ways of reconciling the conflict between the comprehensive plan and the zoning ordinance, which did in fact lead to a compromise solution. More significantly, the court endorses and carefully applies a rational basis test for determining the legitimacy of the city's decision to reject the plan amendment sought by the landowner, recognizing the legislative nature of the decision and according the city council due deference. This generous deference has been the general rule since the United States Supreme Court's landmark decision upholding zoning in *Village of Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926).

For further discussion of the role of the comprehensive plan, see *Powell on Real Property* § 79C.02 (Michael Allan Wolf ed., LexisNexis Matthew Bender), *Zoning and Land Use Controls* § 37.03 (Eric Damian Kelly, ed., LexisNexis Matthew Bender), *Zoning Law and Practice* § 5-2 (LexisNexis), *Regulatory Takings* § 3-3 (LexisNexis), and *Land Use Law* § 3.13 (LexisNexis).

For further discussion of open space preservation, see *Powell on Real Property* § 79C.03 (Michael Allan Wolf ed., LexisNexis Matthew Bender), *Zoning Law and Practice* § 7-23 (LexisNexis).

For explorations of regional planning, see *Powell on Real Property* §§ 79B.03, 79D.06 (Michael Allan Wolf ed., LexisNexis Matthew Bender) and *Zoning and Land Use Controls* § 33.01 (Eric Damian Kelly, ed., LexisNexis Matthew Bender).

For more on mandamus and other remedies in zoning disputes, see *Zoning and Land Use Controls* § 52.06 (Eric Damian Kelly, ed., LexisNexis Matthew Bender), and *Zoning Law and Practice* § 29-2 (LexisNexis), and *Land Use Law* § 8.14 (LexisNexis).

For analysis of the Standard State Zoning Enabling Act, see *Powell on Real Property*, § 79C.03 (Michael Allan Wolf ed., LexisNexis Matthew Bender); *Zoning and Land Use Controls*, §§ 35.03[2][a] (analysis), 53B.01 (Act) (Eric Damian Kelly, ed., LexisNexis Matthew Bender).

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73 of 79 DOCUMENTS

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Professor Roger Bernhardt on Behniwal v. Mix

2008 Emerging Issues 819

Professor Roger Bernhardt on Behniwal v. Mix, 147 Cal. App. 4th 621, 54 Cal. Rptr. 3d 427 (February

By Roger Bernhardt

October 30, 2007

SUMMARY: Read expert commentary on the California appellate court decision in *Behniwal v. Mix* (2007) 147 Cal. App. 4th 621, an action seeking specific performance of a residential purchase where the trial court erred in deducting from the purchase price the amount of contractual attorneys fees awarded the buyers and, by doing so, converted what would be, at best, the basis for a judgment lien against the sellers' property into a pre-existing special lien with super-priority over all other liens on the property.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Background. The decision in *Behniwal v. Mix*, 147 Cal. App. 4th 621, 54 Cal. Rptr. 3d 427 (2007), makes it difficult to advise a buyer on how valuable the attorneys fees clause in her contract might prove if she proceeds with litigation over it. The buyers here prevailed in their suit for specific performance on a \$540,000 property and won attorneys fees of \$250,000. The trial court ruled--and most attorneys would have probably thought it was right--that the buyers only needed to pay the sellers the \$190,000 difference. Offsetting debts are treated as having already been paid, pro tanto.

But because the Court of Appeal held that a party has no right to an offset where it would interfere with the rights of third parties under the rules of lien priorities, this meant the attorneys fee award came in behind three deed of trusts given by the sellers (two of them to their own attorneys) and also behind a homestead exemption, all of which events were taken with notice of, and recorded after, the buyers had filed their lis pendens.

Notice of Attorneys Fees. So attorneys should not count a lis pendens as giving notice of the attorney fees provision in the contract the same way as a foreclosure includes the claim for trustee or attorney fees that relate back to the date of the original deed of trust being foreclosed on. The reasoning is that the filing of a lis pendens gives notice only as to the legal proceeding involving the subject property, not to any possible attorney fee award. In fact, according to the court, a lender might even reasonably rely on the pleadings to conclude that the property could be safely encumbered up to [the purchase price in the contract]. Although this might seem counterintuitive, the holding is that contractual attorney fees are an independent money judgment, not a clear incident to the lawsuit that third parties can be charged with knowing.

The *Behniwal* decision thus leaves lawyers with little advice to give a client considering attorneys fees in litigation,

clearly a matter of importance affecting the clients decision to go to court. With the right clause, fees may be awarded, but they may not be collectible. If a client assumes automatic collectibility because success in the litigation will lead to purchase of the defendants property, a reduction of the price by that much is no longer guaranteed.

Liens Already on Property and Liens Imposed After Filing of Suit. Everything will depend on the liens already on the sellers property *and on the liens imposed after the lawsuit has been filed*. The seller--especially a cash-poor seller as seems to have been the case here--has that last-resort strategy of lienning up her property even after the lis pendens has been filed so that the seller can bankroll her defense, even to the extent of having her own--losing--attorneys paid ahead of the victorious ones. When the fees amount to a quarter-million dollars, it matters.

Cross References

Matthew Bender Practice Guide: California Pretrial Civil Procedure, Ch. 21, Lis Pendens

Matthew Bender Practice Guide: Trial & Post-Trial Civil Procedure, Ch. 25, Collecting Attorneys Fees From Client

Matthew Bender Practice Guide: Trial & Post-Trial Civil Procedure, Ch. 25A, Recovering Attorney's Fees From Opposing Party

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74 of 79 DOCUMENTS

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Professor Roger Bernhardt on WRI Opportunity Loans II, LLC v. Cooper

2008 Emerging Issues 779

Professor Roger Bernhardt on WRI Opportunity Loans II, LLC v. Cooper, 154 Cal. App. 4th 525 (2007)

By Roger Bernhardt

October 22, 2007

SUMMARY: Get the practical implications of the California appellate court decision in WRI Opportunity Loans II, a case addressing the Legislatures intent in enacting Civ. Code § 1917.005, the statutory exemption to the states usury law.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: This decision has two important holdings that a lenders attorney should watch out for.

Contingent Interest Provision. First, to escape the usury limit by way of the contingent deferred interest loophole, the excess charges must be truly contingent. They cannot amount, in substance, to an absolute burden imposed on the borrower. In this case where construction of a residential development was being financed with the expectation that some 60 condominiums and town houses would be built and sold, the lender was loaning **\$3 million for two years with an absolute interest obligation of \$1.4 million and a contingent interest obligation of another \$1.3 million.** (According to the opinion, this worked out to 38% interest, although there was no explanation as to why even the base \$1.4 million was not in and of itself usurious.)

To appreciate the courts analysis, one must realize that there were three components in the contingent interest provision, all of which were payable either on sale of a unit or, in any event, by the maturity date of the blanket note:

. First, for units sold to outsiders, whether finished or under construction, the contingent interest was 5% of the sales price.

. Second, for units sold to insiders, whether finished or under construction, the contingent interest was 4.5% of the sales price or 4.5% of a budgeted gross sales price, set at between \$420,000 and \$556,000.

. Third, for units not yet under construction and unsold, the contingent interest was set at \$1.4 million, less what had been received under the first two contingencies. (There was no mention of a fourth contingency: units built but not sold.)

The court held that, because the first three possibilities covered everything, there was nothing contingent in

the deal. WRIO was, according to it, guaranteed a significant amount of interest regardless of the projects success.

Certainly the third contingent interest component made the overall formula suspect because it amounted to nearly doubling the interest on unbuilt units. But since the facts do not show whether there were any such parcels, readers cannot know to what extent that feature tainted the other two formulas by its mere presence in the loan agreement.

At the very least, it would seem safer for WRIO to have limited the contingent interest provision to parcels that were actually sold and to have dealt with the risk of nonconstruction (which it claimed to have been worried about) in some way other than through the contingent interest provisions. However, it would still remain unclear whether an interest provision such as this one would be valid even when not applicable to unbuilt lots. Given that this was raw land to begin with, how is appreciation to be calculated? If raw land was acquired at, say \$5,000 per lot, and the houses to be constructed were initially budgeted at, as here, approximately \$500,000 each, and thereafter sold for only \$400,000, would a contingent interest charge of 5% on \$400,000 or \$500,000 still be appropriate? How contingent interest plays out in the construction field is not clear.

Guarantor Issue. Second, the guarantor issue may be no less important to lenders. These guarantors were the sole principals of the borrowing LLC, although the issue of alter ego defenses was never mentioned in the opinion. Instead, while acknowledging that guarantors are generally capable of waiving defenses and that *Civil Code* § 2856 appears to extend a broad rule of waiver for the protection of lenders, the opinion held that this code section did not give a lender a defense against a usury claim. The explanation was twofold, and it is not clear which was the more significant one. On the one hand, the court said that the waiver language did not include usury, which would imply that a better drafted waiver could eliminate that difficulty. But, on the other hand, it also said that usury was a different sort of defense from those enumerated in the various suretyship code sections, relying on some older cases and a superseded section from the Restatement of Security, now replaced by the Restatement (Third) of Suretyship & Guaranty; in that case better language in the documents would not help--a different statute would have to be drawn.

Cross References

- . California Legal Forms--Transaction Guide, Ch. 25, *Real Estate Loans*, § 25.15[13] (Matthew Bender)
- . California Legal Forms--Transaction Guide, Ch. 79, *Suretyship, Guaranty, and Indemnity* (Matthew Bender)
- . California Forms of Pleading and Practice, Ch. 538, *Suretyship, Bonds, and Undertakings* (Matthew Bender)
- . California Forms of Pleading and Practice, Ch. 568, *Usury* (Matthew Bender)

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75 of 79 DOCUMENTS

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William M. Hensley on Advantec Group, Inc. v. Edwin's Plumbing Co., Inc.

2008 Emerging Issues 750

William M. Hensley on Advantec Group, Inc. v. Edwin's Plumbing Co., Inc., 153 Cal. App. 4th 621, 200

By William M. Hensley

October 9, 2007

SUMMARY: William M. Hensley provides practical advice on the important implications of the California appellate courts ruling in *Advantec Group, Inc. v. Edwin's Plumbing Co.*, where the court found that a defendant's answer containing a general denial of the material allegations of a contractor's claim was sufficient to controvert the contractor's allegation of licensure, and thus invoked the requirement of Bus. & Prof. Code § 7031(d) that the contractor prove licensure by producing a verified certificate.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Introduction: Suing Contractor Must Prove it Has Valid Contractors License

California Business & Professions Code § 7031, subdivision (d), one of the subsections of the Contractor Licensing Law, requires that a suing contractor must prove that it has a valid contractors license, if the issue of licensure is controverted by the defending party, through production of a verified certificate from the Contractors State License Board. Until *Advantec Group* was decided, the procedural impacts of how this provision worked during trial of a contested matter had not been fully explored. However, it was flushed out in detail by the Second District Court of Appeal in *Advantec Group* and has important ramifications that cannot be ignored by any litigating attorneys when representing contractors during a trial of a contested matter.

Implications of *Advantec Group*

What implications arise from *Advantec Group*? Several, as described below.

Controverting the Licensure Issue. First, the Court of Appeal in *Advantec Group* determined that a defending party's general denial of allegations by a plaintiff that it was properly licensed served to controvert the licensure issue for purposes of Bus. & Prof. Code § 7031(d). The implication from this holding is that the defense does not have to do much to put the licensure at issue, given that most of the complaints I see from contractors are unverified in nature and in response draw answers with general denials/affirmative defenses only. This reality of real world practice means that

plaintiffs representing contractors--whether general or subcontractors--must be prepared to obtain the State License Board verified certificate of licensure in order to meet the controverted response of the defendant through the filing of a simple answer with general denials of the contractor licensing allegations by plaintiffs.

General Denials; Contesting the Licensure Issue. Second, attorneys representing defendants need to generally deny any unverified allegations of licensure and then hold their cards until trial, trying not to tip their hand that plaintiff needs to obtain a verified certificate from the State License Board and attach it as an trial exhibit. Before *Advantec Group* was decided, it was unclear whether defendants had to raise the licensure issue through pleading of a generalized affirmative defense (such as Lack of Contractor License) or had to posit the issue through pleading a special plea of abatement (either through an affirmative defense in the answer or through the filing of a demurrer). However, it was my experience that the more careful practitioners *would* plead the licensure issue as an affirmative defense, which frequently tipped off plaintiffs that this would be something they needed to address through evidence (with discerning plaintiffs actually obtaining the certificate from the State License Board). *Advantec Group* put to rest the notion that the defense must present an affirmative defense or file a demurrer to contest the licensure issue; rather, a simply general denial in an answer would suffice. This means that the defense can simply deny and lie in wait, hoping that a suing plaintiff contractor does not know about § 7031(d) and ambushing the plaintiff at trial.

Meeting Plaintiffs Burden of Proof: Obtain Certificate From State License Board. Third, plaintiffs need to understand that they must introduce the certificate from the State License Board to meet their burden of proof. At the trial in *Advantec Group*, plaintiff tried to offer witness testimonial evidence to satisfactorily prove that it had a valid contractor license. Eventually, both the trial and appellate courts found that this proof was insufficient, because *Bus. & Prof. Code § 7031(d)* required the certificate instead. Plaintiffs should simply avert this trap by obtaining the necessary certificate and attach it as a trial exhibit. Alternatively, a suing plaintiff could propound discovery to the defense for purposes of fleshing out if the licensure issue is being contested. If the defense responds in the negative, that likely will satisfy the issue. However, why gamble? Better to obtain the certificate and put the evidentiary issue to rest.

Suing Plaintiffs Should Not Rely on Trial Judge to Grant Continuance. Fourth, *Advantec Group* teaches suing plaintiff contractors that they cannot rely on the trial judge to grant a continuance for them so as to remedy their failure to have a State License Board certificate if the licensure issue has been controverted by the defense. *Advantec Group* involved a jury trial, with the trial judge denying plaintiffs trial continuance request because he felt that it would prejudice jurors who were at the end of a four day trial and he did not want to delay the case while the certificate was being obtained. The appellate court affirmed the lower courts decision to deny a trial continuance. I believe that, like the trial judge in the case, most lower courts would not continue a jury trial to rescue plaintiff contractors, because the delay in obtaining the certificate would disrupt proceedings and might lead to a mistrial. Even if the matter was a bench trial, most judges--in my opinion--would likely deny a further postponement, believing that it was plaintiffs responsibility to know what the law was and to know what *Bus. & Prof. Code § 7031(d)* required. That is certainly what *Advantec Group* held as a basis for affirming the denial of the plaintiffs trial continuance request.

Conclusion

Lessons abound from this decision for both sides of a lawsuit. Plaintiffs can avoid trouble by getting the certificate, while the defense can set up a trap for unwary plaintiffs by simply denying licensure allegations and see if plaintiffs know their proof burdens under *Bus. & Prof. Code § 7031(d)*.

Cross References

- . 1 Kiesel et al., Matthew Bender Practice Guide: California Pretrial Civil Procedure 7.10[6], 14.14
- . 2 Crompton et al., Matthew Bender Practice Guide: California Contract Litigation, 18.06[2][a], 18.29

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76 of 79 DOCUMENTS

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Moskovitz on Action Apartment Ass'n, Inc. v. City of Santa Monica

2008 Emerging Issues 480

Moskovitz on Action Apartment Ass'n, Inc. v. City of Santa Monica

By Myron Moskovitz

August 30, 2007

SUMMARY: Professor Myron Moskovitz on the practical implications of the California Supreme Courts decision in *Action Apartment Assn, Inc. v. City of Santa Monica*. Here, the Court addressed whether an apartment building owner could challenge the City of Santa Monicas Tenant Harassment ordinance, which prohibits a landlord from maliciously serving an eviction notice or bringing any action to recover possession of a rental unit without a reasonable factual or legal basis. Professor Myron Moskovitz is a Professor at Golden Gate University School of Law.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: At first glance, the California Supreme Courts decision in *Action Apartment* appears to split the baby in half. The Court strikes down part of the Citys ordinance, but upholds (with a limitation) the other part. As a practical matter, however, the Court did more for the City and tenants than for the landlords.

Preemption by Litigation Privilege. First, the court deals with the section of the ordinance that provides that no landlord shall, with malice, bring any action to recover possession of a rental housing unit based upon facts which the landlord has no reasonable cause to believe to be true or upon a legal theory which is untenable under the facts known to the landlord. The ordinance permits either the City or the affected tenant to sue the landlord for violating this provision.

The Court held that this section is entirely preempted by the litigation privilege. Therefore, neither the City nor the tenant may use this section as a basis for suing the landlord who brings an unlawful detainer suit with malice and without reasonable cause.

Suit for Malicious Prosecution. But nothing in the Courts decision bars the tenant from suing the landlord who brings such an eviction suit for the tort of *malicious prosecution*. Indeed, the Court expressly stated: A tenant who has successfully defended against an eviction action may, of course, bring an action for malicious prosecution. And, as the Court noted, to sue for this tort, the plaintiff must prove the requirements of favorable termination, lack of probable cause, and malice. The ordinance failed to mesh with these requirements only because it did not include the first requirement: *termination* of the unlawful detainer action. Thus, the ordinance permitted the City or tenant to sue for

violation of the ordinance *while the unlawful detainer suit was pending*.

The loss of this ordinance remedy *to the tenant* is inconsequential--because the malicious prosecution remedy is just as good. As the Court noted, the requirements of the two remedies are virtually identical, though to sue for malicious prosecution, the tenant will have to wait until the eviction suit is concluded. But as a practical matter, there will seldom be any good reason for the tenant to sue the landlord so quickly, while the eviction suit is still pending. Better to wait until it is over, so the tenant can allege in his or her suit against the landlord that the landlord lost the eviction case. Also, the tenants *damages*--his or her costs and attorneys fees from defending the eviction case, plus possibly damages for emotional distress--will be more certain after the eviction case is over.

The City, however, has no standing to bring a malicious prosecution case on behalf of the tenant, and the City itself is not damaged by the landlords unfounded unlawful detainer suit against the tenant. So to this extent, the Supreme Courts decision does hamper a citys efforts to make the ordinance effective. How much depends on how many private attorneys are willing to represent tenants in bringing malicious prosecution cases.

Notices to Quit--Implications. Second, the Court upheld the ordinance to the extent it prohibits the landlord from service of any notice to quit or other eviction notice with malice and without reasonable cause. This, in the real world, is where it counts.

As the Court noted, after the states Costa-Hawkins Act mandated state-wide vacancy decontrol, whenever market rents begin to outpace rent controlled rents, landlords have a strong financial incentive to get tenants to move out--in order to bring in a new tenant at market rent. The Santa Monica City Council found that landlords were using phony notices (e.g., owner move-in notices when there was no intent to move in) to accomplish exactly this. I suppose that these notices only rarely resulted in eviction lawsuits, because the evidence supporting the notices was simply too flimsy, and the tenants attorney could easily win the lawsuit (and, perhaps, follow it up with his or her own malicious prosecution action against the landlord).

By permitting both the City and the tenant to sue the landlord for violating the ordinance by serving phony notices, the Court left a real weapon intact. The Court did rule that, in a specific case, the landlord might defend by showing that when he or she served the notice, the landlord contemplated bringing the eviction action in good faith and under serious consideration. This is not much of an additional limitation, because the ordinance already requires the City or tenant to prove that the landlord served the notice with malice. The limitation might matter, however, in cities that have ordinances that permit the city or the tenant to sue a landlord who loses an eviction lawsuit--*without* proving that the landlord acted with malice or without probable cause.

In sum, *Action Apartment Association* was a victory for cities and tenants.

Incidentally, the attorney who argued the case for the City had an earlier opportunity to practice his argument--at the Moot Court for Practicing Lawyers program that I provide at Golden Gate University School of Law. If anyone is interested in arguing a case before some law professors and practicing attorneys, let me know at mmoskovitz@ggu.edu.

Cross References: Westley & Saltz, Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 4, *Termination of Tenancy*, 4.05

Westley & Saltz, Matthew Bender Practice Guide: California Landlord-Tenant Litigation, Ch. 8, *Local Rent and*

Eviction Controls

California Forms of Pleading and Practice, Ch. 335, Landlord and Tenant: Rent Control, § 335.12 (Matthew Bender)

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77 of 79 DOCUMENTS

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Moskovitz on Castaneda v. Olsher

2008 Emerging Issues 481

Moskovitz on Castaneda v. Olsher

By Myron Moskovitz

August 30, 2007

SUMMARY: Professor Myron Moskovitz on the practical implications of the California Supreme Courts decision in *Castaneda v. Olsher*. The Court here found that a property owner did not have a duty to refuse to rent to gang members. Professor Myron Moskovitz is a Professor at Golden Gate University School of Law.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: The Issue: Advising Property Owners. As the California Supreme Courts citations indicate, there are many California cases dealing with a property owners duty to protect his or her tenants and guests from the criminal acts of third parties. Almost all of these criminal act cases arise the same way: the trial court sustains a demurrer or grants summary judgment, directed verdict, or nonsuit for the defendant, and the plaintiff appeals. Thus, the issue on appeal is whether there is sufficient evidence to permit a reasonable jury to find liability.

In the real world, this is the issue that counts. Jury trials are expensive, no matter who wins. And once the case gets to a jury, anything can happen. Because the plaintiff is blameless--and injured--and the owner is at least somewhat at fault (and, perhaps, wealthy), the jury might well return a substantial verdict for the plaintiff. You cannot stop lawsuits from being filed, but you might block the case from going to the jury. And this is what *Castaneda* and the other cases are about. So, as a practical matter, the real issue is: what should a lawyer advise his or her owner-client to do to minimize the likelihood that the clients actions will lead to a lawsuit that will get to a jury? (Im leaving aside the moral question of why landlords should try to protect their tenants.)

Owner Has No Duty to Refuse to Rent. *Castaneda* involves a small subset of these cases, where both the plaintiff and the third party are tenants of the same owner. The California Supreme Court held that this raises special considerations not present when the third party is a stranger to the property.

First, the Court held that the owner has no duty to *refuse to rent* to suspected gang members, because the result in many cases would be arbitrary and illegal discrimination on the basis of race, ethnicity, family composition, dress and appearance, or reputation. The Court rules (in *dicta* I suppose) that these refusals would be in at least some circumstances, violations of Californias Fair Employment and Housing Act (FEHA) and the Unruh Civil Rights Act. This in itself should serve as a warning regarding possible liability for refusing to rent to suspected gang members based on how they dress and the like.

But the Courts language should not be read to establish blanket immunity for landlords who knowingly ignore clear signs of potential trouble. The Court held that the landlord need not investigate. But it seems to me that if the landlord *knows* the prospective tenant (or someone who will live with that tenant) has a record for violent crimes or is involved with a gang that has a history of violence, the wiser course might be to refuse to rent to them. These facts are more solid than the vague facts present in *Castaneda*. Here, the rock of tort liability seems more hazardous than the hard place of facing a lawsuit for discrimination under the Unruh Act.

Owners Duty to Evict. Second, the Court held that the owner has a duty *to evict* only in cases where the tenants behavior made violence towards neighbors or others on the premises highly foreseeable. The term highly foreseeable sets the bar higher than the usual tort standard: foreseeable. This was no accident--the Court meant what it said, as shown by how it applied the standard to the facts.

Here again, the landlord might be faced with a tough choice when he or she becomes aware that a tenant is behaving badly towards other tenants. Do I incur the cost and risks of eviction, or do I take the chance that the tenant will hurt someone else--who might then sue me? While the highly foreseeable standard would seem to bar most tort suits, you never know. In *Castaneda*, the owner had no clear information that the gang member tenant had hurt or threatened anyone with violence, so the landlord won. But if your client has received clearer evidence of violent or threatening behavior, the more prudent course might be to bite the bullet and try to evict the tenant.

A very similar issue arises more frequently: a tenant is not dangerous, but habitually noisy, via a loud stereo or parties, and other tenants threaten to move out, sue, or withhold rent. The highly foreseeable standard will come into play if the other tenants sue the landlord for the tort of maintaining a nuisance. But the complaining tenants might instead invoke--by lawsuit or rent withholding--the implied warranty of habitability, which (so far) does not employ that higher standard. None of these remedies are pleasant for the landlord, so the better course might well be to take steps--even eviction--to try to stop the nuisance.

Cross References. Westley & Saltz, Matthew Bender Practice Guide: California Landlord-Tenant Litigation, 6.196.23.

California Forms of Pleading and Practice, Ch. 334, Landlord and Tenant: Claims for Damages, § 334.13 (Matthew Bender)

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78 of 79 DOCUMENTS

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The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis

2008 Emerging Issues 479

The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis

By Robert M. Jaworski

August 29, 2007

SUMMARY: Expert Robert M. Jaworski, Esq. analyzes the "perfect storm" that has hit the subprime mortgage industry. Including what caused the storm and what the effects of the storm have been. This Emerging Issues Analysis will outline some of the apparent causes for the perfect storm that has hit the subprime mortgage industry and some of its immediate effects, and then focus on the legal issues likely to emerge in its aftermath.

PDF LINK: Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge

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ARTICLE: In meteorological terms, a perfect storm is a storm whose intensity is magnified by the convergence of several distinct weather events. A perfect storm is not necessarily confined to the weather, however, as current events in the subprime mortgage loan business demonstrate. This commentary will outline some of the apparent causes for the perfect storm that has hit the subprime mortgage industry and some of its immediate effects, and then focus on the legal issues likely to emerge in its aftermath.

Like other perfect storms, the subprime mortgage lending crisis had not just one cause, but many. And the causes were a long time in the works.

The Causes

Loan Originations Declined as Interest Rates Rose. The origins of this storm can be traced back to the long refinance boom which ended only a few years ago when mortgage interest rates began their steady climb from record low levels. During the boom, industry players (investment banks, lenders and brokers alike) profited handsomely from unprecedented origination activity, and, no doubt, expected those levels of profitability to continue. As interest rates inched higher, however, originations (and profits) declined.

Marketing of Exotic Loan Products. To reverse this decline, keep up the flow of originations to the secondary market, and-it should not be forgotten-allow more people to achieve the American dream of home ownership, lenders

and brokers began to aggressively market more exotic loan products. These included:

interest-only and payment-option adjustable rate mortgages (ARMs), originally intended for use by sophisticated real estate investors and professionals (Nontraditional mortgage loans or NTMs);

reduced documentation loans, originally intended for use by self-employed borrowers and other borrowers who possessed the necessary income and/or assets to qualify but, for one reason or another, had difficulty being able to document that ability consistent with Fannie/Freddie underwriting standards (stated income loans);

2/28 or 3/27 ARM loans, ARM loans with an initial 2- or 3-year period during which the interest rate would remain fixed; and

so-called 80-20 piggyback loans, 80% loan-to-value (LTV) first-lien loans combined with 20% LTV second-lien loans, designed to eliminate the need for expensive private mortgage insurance.

Making the Loan Work. Marketing efforts concerning these more exotic loan products were often directed to borrowers for whom these loans may not have been a good fit and were boosted by the use of below-market teaser rates that would be in effect, typically, for only a short initial period. Moreover, the features of these various types of loans were often combined to make the loan work, *i.e.*, so that the loan could close. The result was as desired—more originations. But this increase in originations also sowed the seeds for the current crisis.

Speculation and Fraud also played a part in this perfect storm. Real estate speculators used these exotic products to purchase properties without having to put up a lot of their own money or prove income and assets. Borrowers (and/or loan officers in some cases) exaggerated income on stated income loans (dubbed by some, for this reason, as Liars loans) in order to obtain loans for which they would not otherwise have qualified. And criminals found that many of the features of these loans made it easier to perpetrate property-flipping and other illegal schemes.

Expectation that Interest Rates Would Remain Stable and Home Values Appreciate. Generally, however, the perception of all involved at the time was that these were good loans. Lenders, secondary market purchasers of these loans, and borrowers (at least those who understood their loans) felt confident that interest rates would remain stable and perhaps even decrease, and that home values would continue to appreciate, thereby enabling the borrowers to refinance before their loans reset. Borrowers were also optimistic— as they almost always are—that their financial situations would improve. (Unfortunately as well, many borrowers may not have fully appreciated when their loans closed how drastically their payments could change under certain situations.)

Regrettably for all concerned, interest rates did not remain stable, but rose; borrowers financial situations on the whole did not improve; and, most importantly, home values did not continue to appreciate, and in some areas of the country, actually fell. The perfect storm was upon us.

Immediate Effects

Preventive Action in 2006—Too Late. Realizing that some of these more exotic loans carried significant repayment risk, having been underwritten for the most part at the loans initial interest rate rather than the fully-indexed rate, the federal bank regulators took preventive action late in 2006, too late however to ward off the storm. They issued formal Interagency Guidance on Nontraditional Mortgage Product Risks (Guidance) to the banking industry which requires banks (and other lenders, following the decisions of many state mortgage regulators to adopt the CSBS/AARMR version of the Guidance n11) to employ more vigorous underwriting standards in connection with these loans and to do a better job of alerting consumers to their potential pitfalls (which, coincidentally, may make it more difficult for banks to refinance these borrowers into new loans when their existing loans reset) [71 *Fed. Reg.* 58609 (October 4, 2006)].

Decrease in Loan Purchases-Increase in Enforcement-Subprime Lenders Going Out of Business. Seeing all of this, secondary market purchasers of subprime loans, already nervous about the quality of their loans and perhaps also the financial stability of their loan sellers, cut back on their purchases of new subprime loans and, at the same time, demanded that sellers buy back some of these loans. At this time also, state regulators began to ramp up enforcement efforts against subprime lenders. The result was that upwards of 20 subprime lenders, including some of the nations largest (*e.g.*, New Century Financial Corp. [New Century], Mortgage Lenders Network, USA, Inc., and Ownit Mortgage Solutions), were forced to go out of business, and others were forced to sell loan pools on the scratch and dent market at substantial discounts, seek out emergency sources of liquidity to enable them to carry on their businesses and/or search for buyers.

Goals. Against this backdrop, state and federal legislators, and regulators, began to search for solutions, both to deal with the potential for a substantial increase in foreclosures when these loans reset and to prevent a recurrence of this perfect storm.

Responses

New Ideas; New Impetus for Old Ideas. Actions aimed at dealing with the ramifications of the perfect storm and to prevent a recurrence are being taken, and will likely continue to be taken, simultaneously, in both the legislative and regulatory arenas, as well as in the courts.

Legislative Responses. Congress is considering numerous federal legislative initiatives to deal in one way or another with the subprime crisis. These include various bills, and bill proposals, to beef up protections against predatory lending, to regulate mortgage lenders and brokers on the federal level, to make it tougher for mortgage holders to foreclose, to expand the FHAs authority to allow it to refinance more subprime loans, and to make money available to prevent foreclosures. Which of these bills, if any, will be enacted and what form they will take is unknown, but it appears from the tenor of the debates so far that providing federal dollars to stem the anticipated tide of foreclosures (branded by some members of Congress as a bailout) has the least chance of success, whereas expansion of the FHAs authority is viewed as a fairly likely outcome. In addition, some form of federal anti-predatory legislation or regulation seems likely to become a reality, with Congress seeming to want the Federal Reserve Board (FRB) to use its regulatory authority to deal with this issue rather than to have to deal with it itself.

Two other proposals are likely at least to be debated:

1. a proposal to limit or eliminate holder-in-due course protection for loan purchasers, which would in effect enlist the help of secondary market participants to police lenders and brokers; and
2. a proposal to impose a suitability standard on mortgage lenders and/or a fiduciary duty upon mortgage brokers.

More about these proposals later.

State Legislatures have also been busy attempting to deal with the subprime situation, and their responses have been even more varied than those being floated in Congress. They include efforts such as the following:

To enact, or strengthen existing, comprehensive anti-predatory legislation;

To place a fiduciary responsibility or a standard of good faith and fair dealing upon mortgage brokers in their dealings with borrowers;

To require individual loan originators to be licensed and to meet prescribed educational and/or testing requirements;

To restrict the advertising and marketing practices of lenders and brokers, particularly with respect to ARM loans;

To impose upon lenders a requirement that they verify the borrowers income and/or determine that the borrower has the ability to repay the loan and/or be able to demonstrate that a refinance loan will provide the borrower with a tangible net benefit;

To criminalize mortgage fraud;

To increase resources devoted to enforcement efforts connected to mortgage lending; and

Generally, to raise standards for mortgage lenders and mortgage brokers.

As one would expect, the foreclosure process has also received much attention by state legislators. Proposals in this area include:

Foreclosure moratoriums, voluntary or otherwise;

The insertion into the foreclosure process of additional consumer protections;

Government requests for lender forbearance; and

Establishment of rescue funds to prevent foreclosures.

Regulatory Responses. The big question in terms of administrative agency responses to the subprime crisis is what will the FRB do now that it has had its June 14, 2007 hearing on Subprime Lending. The FRB is authorized by the Home Ownership and Equity Protection Act (HOEPA), n22 to prohibit, by regulation or order, acts or practices in connection with

(A) mortgage loans that [it] finds to be unfair, deceptive, or designed to evade the provisions of this section; and

(B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. [15 U.S.C. § 1639 (1), (2).]

However, the FRB has indicated that it will proceed cautiously in this regard.

Other federal agencies may also play a role. The General Counsel of the Federal Deposit Insurance Corporation (FDIC) has recently raised the possibility that federally insured depositories might have to hold capital against some securitized mortgage loans, to protect against the risk of buyback demands. In addition, representatives John Dingell (D-Mich.) and Barney Frank (D-Mass.) have urged the Federal Trade Commission and the FDIC to do more to safeguard consumers in light of the U.S. Supreme Courts decision in *Watters v. Wachovia Mortgage* (which held that the states were preempted from enforcing their laws against operating subsidiaries of national banks) [127 S. Ct. 1559 (April 17, 2007)].

Recently, the federal bank regulators released their final Statement on Subprime Mortgage Lending (Subprime Guidance) [72 Fed. Reg. 37569 (July 10, 2007)]. The Subprime Guidance requires banks to analyze a borrowers capacity to repay the loan according to its terms, and to take into account both principal and interest obligations at the fully indexed rate with a fully amortizing repayment schedule, plus a reasonable estimate for real estate taxes and insurance, whether or not escrowed. Consistent with this requirement, the Subprime Guidance encourages banks to use debt-to-income ratios, including, specifically, front-end ratios (the percentage of monthly gross income necessary to meet the borrowers monthly housing expense, including principal, interest, real estate taxes and insurance) to quantify a borrowers repayment ability, *particularly* if the bank is going to rely upon reduced documentation, piggyback second mortgages, or other (risk layering) features that significantly increase the risk to both the bank and the borrower. With respect to stated-income loans, the Subprime Guidance allows banks to make such loans only in exceptional

circumstances, *i.e.*, where verified and documented mitigating factors exist that will clearly minimize the need for direct verification of the borrowers income.

Finally, by focusing greater scrutiny on consumers understanding (or lack of understanding) concerning these more exotic mortgage products, the subprime crisis may also provide a boost to HUDs efforts to adopt rules designed to achieve comprehensive RESPA reform, which, of late, have focused on improving and enhancing the good faith estimate of closing costs to make it something upon which consumers can place greater reliance.

State mortgage and securities regulators have also been busy. Reportedly, the U.S. Securities and Exchange Commission (SEC) is looking into New Centurys restatement of financial results announced this past February, and the U.S. Attorneys Office for the Central District of California is conducting a criminal inquiry into trading in New Centurys stock and accounting errors.

In addition, State mortgage regulators in a number of states have issued cease and desist orders against New Century and other subprime lenders for failing to fund loans that have been closed and for other violations. Many states also adopted the Subprime Guidance issued by the federal bank regulators almost immediately after it came out, and more are expected to do so. And some have developed or are considering developing Best Practices guidelines for mortgage bankers and bankers to follow.

Litigation Responses. Litigation responses to the subprime crisis have only just begun. Securities class actions have been started against several subprime lenders that are public corporations. Secondary market purchasers of subprime loans have sued lenders for failing to honor buy back demands and/or to account for missing escrow payments. While borrowers have been attempting for some time now to defend against foreclosures by alleging improprieties in the origination of their loans, such tactics will no doubt become more prevalent as the publicity attached to the subprime crisis accelerates and more and more of the blame for the crisis is placed-rightly or wrongly-on lenders and brokers. Employees of the now-defunct subprime lenders will likely sue for unpaid compensation. And plaintiffs class action attorneys will be searching for opportunities to sue subprime lenders. (Of particular interest to them in this regard may be a settlement of a class action recently entered into by Wells Fargo Bank in which it was claimed, among other things, that Wells Fargo failed to give subprime borrowers accurate information about their loans.)

Even investment banks will not be immune from legal actions as a result of this crisis. Bondholders have already filed suit against one investment bank for failure to disclose risks involved with the purchase of bonds backed by subprime loans. And the Ohio Attorney General has indicated that he intends to sue not only lenders, but also investment banks, on behalf of borrowers and the Ohio Public Employees Retirement System (which invested in bonds backed by subprime mortgages).

Finally, an interesting class action lawsuit has been filed in New York Supreme Court which threatens to alter the relationship in that state between lenders and the mortgage brokers who place loans with them. The complaint contends that mortgage brokers act as *agents* of their lenders, thereby making the lenders liable for any misdeeds committed by the broker during the origination process. Using this theory, plaintiffs hope to have the lender held liable, specifically, for the mortgage brokers alleged falsification of loan documents that enabled the borrowers to obtain loans in amounts far beyond their ability to repay.

Legal and Policy Issues

Numerous and Complex Legal and Policy Issues are raised by the responses to the subprime crisis highlighted above, including:

Should comprehensive federal anti-predatory legislation, if enacted, preempt similar state and local laws?

Should stated income loans be regulated?

Would more disclosure concerning the risks involved with NTMs, stated income loans, 2/28 and 3/27 ARM loans, and 80-20 piggyback loans, significantly increase consumers understanding of these products and, in so doing, significantly reduce their risk?

Should prepayment fees be eliminated?

Should non-bank mortgage lenders and brokers be licensed at the federal level, and if so, what should be the proper role of the states?

Should mortgage brokers be impressed with a fiduciary obligation or a duty of good faith and fair dealing with respect to their customers, or should their relationship be determined by contract?

Should mortgage lenders be obligated to make sure that the loans they make to borrowers are suitable for them, provide them with tangible benefits and/or are affordable to them?

Would a foreclosure moratorium cause more harm than good?

Should holder-in-due course protections for assignees of residential mortgage loans be eliminated?

A brief discussion of some of the more significant of these issues is set forth below.

Federal Preemption of State and Local Anti-Predatory Lending Laws. This is an issue that is sure to be hotly contested. Should Congress seek to enact comprehensive federal anti-predatory lending legislation, the mortgage industry will no doubt insist upon inclusion of a provision that will preempt any similar state laws and regulations. The industry's fear is that once national standards have been established, presumably following careful consideration by the Congress and with input from all concerned, individual state and/or local government authorities may determine that those standards are too lax or do not go far enough in one regard or another and need to be strengthened; in other words, that recent history-specifically, the enactment in numerous state and local jurisdictions of anti-predatory lending laws and regulations modeled after but that go beyond HOEPA-will repeat itself.

Consumer groups, on the other hand, will likely fight just as hard to keep a preemption provision out of the bill. They will argue essentially that a uniform national standard is simply not flexible enough to meet the needs of borrowers in every locality, *i.e.*, that, because mortgage loan borrowers in one community may face problems different from those faced by borrowers elsewhere or because the communities themselves may be impacted differently as a result of those problems, state and local governments need to have the ability to legislate solutions to these problems at the local level.

Closely associated with this preemption issue is whether such state anti-predatory lending laws, as well as other state consumer protection laws, should apply to federally chartered banking institutions as well as non-bank lenders and brokers. Based on the *Watters* decision and other judicial precedent, it appears from a legal perspective that the answer is no. However, depending upon how the debate proceeds concerning the establishment of comprehensive federal anti-predatory lending standards, the states may well seize the opportunity to attempt to raise this issue before Congress.

Federal Licensing. Also sure to be debated is the issue as to whether or not nonbank mortgage bankers and/or mortgage brokers should be licensed and/or supervised at the federal level. In an effort intended in part to head off such a possibility, state mortgage regulators through AARMR and with the help of CSBS, have been hard at work developing a multi-state licensing system, which is scheduled for implementation beginning in 2008. Despite these efforts, however, the possibility exists that Congress will see a need for more control at the federal level and decide that national licensing is a better alternative. Another possibility is that Congress will allow the states to retain their current licensing authority over non-bank lenders and brokers, but create a separate federal license. Holders of this federal

license, the qualifications for which would presumably be more demanding than existing state law qualifications, would be authorized to do business in every state without having to obtain state licenses.

If a national licensing system were to be put in place, alongside or in lieu of the existing state licensing system, two issues that would have to be dealt with are what law would apply in connection with loans originated in a particular state, and who would enforce that law. States can be expected to lobby hard to preserve their authority in this area.

Suitability. This is yet another touchy subject. Consumer groups have been pushing to force mortgage lenders (and brokers) to make a determination, before closing a loan to a borrower, that the loan is suitable for that borrower. They point to a similar standard currently in place with respect to the sale of securities by stockbrokers on behalf of their clients, which they say has worked well.

Mortgage industry backers have argued, however, that the role of a stockbroker is materially different than that of a mortgage lender. The stockbroker, for example, takes the clients money and invests it, whereas the lender obtains money for the borrower. Also, clients ordinarily look to their stockbrokers for advice as to which stock to buy or sell and when, whereas borrowers historically deal at arms length with lenders, considering them in the same way as a purchaser of a product does the seller. Industry proponents further maintain that a suitability standard should be rejected because it is unworkable, would create enormous potential liability for lenders, and would cut off credit to deserving borrowers.

Holder-in-Due-Course Protection. Finally, there is the question whether or not assignees of residential mortgage loans should continue to possess holder-in-due-course (HDC) protection with regard to the loans they purchase. HDC protection insulates the holder of a mortgage note from most claims and defenses that the borrower may have against the original creditor (or any assignees prior in the chain of title).

Eliminating HDC protection for assignees would mean that, when an assignee purchases a loan, it would also assume legal responsibility for any misdeeds on the part of the originating lender. To protect its investment in the loan as much as possible, and limit its risk, an assignee would then be forced to undertake substantial due diligence concerning both the lender and the loan origination process, in effect, requiring the assignee to supervise its lenders.

Critics of the HDC doctrine maintain that this would be a good thing, since secondary market purchasers of loans are in a better position than borrowers to oversee lenders. However, there are real concerns that elimination of HDC protection for assignees could dry up funds for housing and/or substantially increase the cost of such funds, resulting in significantly higher interest rates for borrowers.

Conclusion

Change is Certain, but the Details are Not. As indicated, the impact of the perfect storm in the subprime lending industry has been severe, and is or will be felt by industry members, employees, investors and consumers alike. Moreover, the debate as to what to do about it will likely be vigorous and public. This virtually ensures that something will be done. The only questions are what will be done, and when.

The most likely outcome is usually the one that offers the least resistance. On the federal level, that would translate to Congress pressuring mortgage holders to practice forbearance (in lieu of foreclosure) when these problem loans reset, but leaving it up to the FRB to adopt rules to deal with the most egregious lending practices that contributed to the subprime crisis. To the extent that such action might then be considered by state and local authorities to be inadequate, these authorities would likely step in to try and come up with additional and discrete remedies.

Nevertheless, the only certainty at this point is uncertainty. No one knows what will happen. Continued vigilance and participation by all concerned in the process will hopefully ensure that the solutions arrived at to deal with the

aftermath of this perfect storm will prove to be helpful, or at least not more harmful than the storm itself.

[Return to Text](#)

n1 CSBS is the Conference of State Bank Supervisors, a trade association whose members are state bank regulators. AARMR is the American Association of Residential Mortgage Regulators, a trade association whose members are residential mortgage regulators. Previous to issuance of their version of the Guidance, these two organizations had combined to work on the design for a multi-state licensing system for non-bank mortgage lenders and brokers.

n2 Chastising the FRB for its failure to act in accordance with this provision, Senator Dodd pointed out, in remarks made during a Senate hearing on subprime lending, that this provision in fact obligates, rather than merely authorizes, the FRB to take action.

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79 of 79 DOCUMENTS

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Eagle on Fashion Valley Mall, LLC v. National Labor Relations Board

2008 Emerging Issues 1921

Professor Steven J. Eagle on *Fashion Valley Mall, LLC v. National Labor Relations Board*, 42 Cal. 4th

By Steven J. Eagle

February 19, 2007

SUMMARY: Review Professor Steven Eagles commentary on the California Supreme Court decision in *Fashion Valley Mall, LLC v. National Labor Relations Board*, 42 Cal. 4th 850, a case that illustrates the clash between private property rights and free expression. The Court ruled, counter to a strong national trend, that labor unions have the right to distribute leaflets in front of stores located within shopping malls, urging the public to boycott those businesses.

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ARTICLE: *Fashion Valley Mall, LLC v. National Labor Relations Bd.*, 42 Cal. 4th 850, 172 P.3d 742, 69 Cal. Rptr. 3d 288, 2007 Cal. LEXIS 14427 (Cal. 2007) illustrates the clash between private property rights and free expression. The Supreme Court of California, ruling counter to a strong national trend, holds that labor unions have the right to distribute leaflets in front of stores located within malls, urging the public to boycott those businesses.

Existing United States and California Supreme Court Precedent. The United States Supreme Courts view of expressive rights on private property has varied over time. In *Marsh v. Alabama* (1946) 326 U.S. 501, 502, 66 S. Ct. 276, 90 L. Ed. 265, it ruled in favor of a Jehovahs Witness seeking to distribute literature on the main street of a company-owned town. In *Amalgamated Food Employees Union v. Logan Valley Plaza* (1968) 391 U.S. 308, 88 S. Ct. 1601, 20 L. Ed. 2d 603, the Court extended this protection to peaceful picketing of a business employing non-union labor within a shopping center. However, in *Lloyd Corp. v. Tanner* (1972) 407 U.S. 551, 92 S. Ct. 2219, 33 L. Ed. 2d 131, it held that a shopping center could prohibit First Amendment activity unrelated to the centers business.

The U.S. Supreme Court subsequently ruled, in *Hudgens v. NLRB* (1976) 424 U.S. 507, 518, 96 S. Ct. 1029, 47 L. Ed. 2d 196, that *Lloyd* was a total rejection of *Logan Valley*. Later, in *Lechmere, Inc. v. NLRB* (1992) 502 U.S. 527, 537538, 112 S. Ct. 841, 117 L. Ed. 2d 79, the Court added that an employer could bar nonemployee union organizers from its property except in the rare case where they had no other effective means of communication.

Although *Lloyd* found no federal constitutional right to engage in free expression in shopping centers, the U.S. Supreme Court ruled that shopping center owners did not have a constitutional right to prevent such expressive activity if it was protected by state law. *PruneYard Shopping Center v. Robins* (1980) 447 U.S. 74, 100 S. Ct. 2035, 64 L. Ed. 2d

741. *PruneYard* affirmed the holding below, in which the California Supreme Court had declared that the state constitution broadly proclaims speech and petition rights. Shopping centers to which the public is invited can provide an essential and invaluable forum for exercising those rights. *Robins v. PruneYard Shopping Center* (1979) 23 Cal. 3d 899, 592 P.2d 341, 347, 153 Cal. Rptr. 854.

Background of Fashion Valley Mall. The Fashion Valley Mall (Mall) permitted expressive activity if a permit were obtained in advance. However, permittees had to agree not to interfere with the business of any of the stores or to encourage customers not to purchase their goods or services. Members of a labor union representing employees of the San Diego Union-Tribune had been ordered to leave the Mall because they were distributing leaflets to customers asking them to boycott a store that advertised in the Union-Tribune, with which the union had a dispute.

The union asserted that the ejection was an unfair labor practice. The NLRB ordered the Mall to cease and desist from prohibiting access. *Equitable Life Assur. Socy of the United States*, 343 NLRB No. 57 (Oct. 29, 2004). Its ruling was appealed to the U.S. Court of Appeals for the District of Columbia Circuit, which noted that an employer may exclude a nonemployee union representative from its property if and only if it has that right under state law. It noted that no California court has squarely decided whether a shopping center may lawfully ban from its premises speech urging the public to boycott a tenant, and certified that question to the California Supreme Court. *Fashion Valley Mall, LLC. v. NLRB* (D.C. Cir. 2006) 451 F.3d 241, 246.

The California Supreme Courts Holding and Dissent. The ensuing 4-3 majority opinion rehearsed California caselaw building upon *Marsh*, such as *Schwartz-Torrance Inv. Corp. v. Bakery & Confectionery Workers' Union* (Cal. 1964) 61 Cal. 2d 766, 394 P.2d 921, 40 Cal. Rptr. 233:

We recognized that peaceful picketing by a labor union involves an exercise of the constitutionally protected right of freedom of speech. We rejected the shopping center's argument that its right to the exclusive possession and enjoyment of private property outweighed the union's right to picket. Because of the public character of the shopping center, however, the impairment of plaintiff's interest must be largely theoretical. Plaintiff has fully opened his property to the public.

Fashion Valley Mall, LLC v. National Labor Relations Bd. (Cal. 2007) 42 Cal. 4th 850, 859, 172 P.3d 742, 69 Cal. Rptr. 3d 288, 2007 Cal. LEXIS 14427 (quoting *Schwartz-Torrance*).

Writing for the dissent, Justice Chin argued that [p]rivate property should be treated as private property, not as a public free speech zone. *Fashion Valley Mall, LLC v. National Labor Relations Bd.*, 42 Cal. 4th 850, 870. Also,

Pruneyard is easily distinguished. The free speech activity that *Pruneyard* sanctioned was compatible with normal use of the property. The opposite is true here. Fashion Valley Mall is a privately owned shopping center. A shopping center exists for the individual businesses on the premises to do business. Urging a boycott of those businesses contradicts the very purpose of the shopping center's existence. It is wrong to compel a private property owner to allow an activity that contravenes the property's purpose.

Fashion Valley Mall, LLC v. National Labor Relations Bd., 42 Cal. 4th 850, 870.

Holdings in Other Jurisdictions. The overwhelming majority of jurisdictions have rejected claims that shopping centers are public fora. See, e.g., *Fiesta Mall Venture v. Mecham Recall Comm.*, 767 P.2d 719, 724 (Ariz. Ct. App. 1988); *Cologne v. Westfarms Assocs.*, 469 A.2d 1201, 1210 (Conn. 1984); *State v. Viglielmo*, 95 P.3d 952 (Haw. 2004);

City of West Des Moines v. Engler, 641 N.W.2d 803 (Iowa 2002); *SHAD Alliance v. Smith Haven Mall*, 498 N.Y.S.2d 99, 102 n.5 (N.Y. 1985); *Southcenter Joint Venture v. Nat'l Democratic Policy Comm.*, 780 P.2d 1282, 1292 (Wash. 1989); *Jacobs v. Major*, 407 N.W.2d 832, 841 (Wis. 1987).

The *PruneYard* rationale has been accepted in a few states. See *Bock v. Westminster Mall Co.*, 819 P.2d 55, 6163 (Colo. 1991); *New Jersey Coalition Against War in the Middle East v. J.M.B. Realty Corp.*, 650 A.2d 757, 780 (N.J. 1994).

Is *Fashion Valley Mall* Applicable to Smaller Stores? There are some recent California Court of Appeal cases suggesting that the state supreme courts *PruneYard* doctrine is not applicable to smaller stores. In *Trader Joe's Co. v. Progressive Campaigns*, 73 Cal. App. 4th 425, 86 Cal. Rptr. 2d 442, 448 (Cal. Ct. App. 1999), the court declared that:

Trader Joes invitation to the public is more limited than the invitation made by a shopping center like PruneYard. Trader Joes invites people to come and shop for food and food-related items. It does not invite them to meet friends, to eat, to rest or to be entertained. Thus, in our view, Trader Joes interest in maintaining exclusive control over its private property is stronger than the interest of a shopping mall owner.

However, shopping centers are not operated for charitable purposes. Amenities exist to sell merchandise. The tension between *Trader Joes* and *Fashion Valley Mall* remains almost palpable.

Cross References

. For a thorough discussion of the points covered in this commentary, see *Regulatory Takings*, 3d ed. (Lexis, 2005).

. See generally California Forms of Pleading and Practice, Ch. 59, *Assemblies, Meetings, and Demonstrations*, § 59.14 (Matthew Bender).

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