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The Intersection of Pet Policies and Anti-Discrimination Laws in Real Estate
By Andrew M. Lieb

Advise real estate owners on drafting and enforcing pet policies requires a comprehensive understanding of not only the interplay of contract and disability law but also the current state of knowledge in the health sciences. When this mixture is neglected or parties proceed in ill-advised manners, disputes about dogs, cats, and other creatures often land in court.

Many housing providers have pet policies contained within their leases and/or house rules. In fact, only around half of landlords surveyed in an Anthrozoös study offered pet-friendly housing. See Carlisle-Frank, Frank and Nielsen: Companion animal renters and pet-friendly housing in the US, 18 Anthrozoös 1, 59–77 (2005). Additionally, of pet-friendly apartments surveyed, only 9 percent allowed a broad range of animals and placed no “significant limitations on size or type.” Moreover, of the tenants with animals surveyed, 82 percent “reported having trouble finding a rental unit that would take their pet(s).” Therefore, the issue of pets in housing has greatly impacted the availability of housing throughout the United States.

Attorneys drafting leases for landlords must advise their clients of the advantages and disadvantages of various pet policies. The main disadvantages to permitting pets, as reported by housing providers, are increased damage to rental units and additional costs such as higher insurance premiums. See Carlisle-Frank, et al. Conversely, the advantage of permitting pets is increased demand for their units from tenants who want pet-friendly housing. Further, attorneys advising landlords must explain the various types of pet policies that are available. Landlords need not simply institute a blanket yes-or-no pet policy. Available policies include pet deposits, restrictions on pet type, the size and number of pets, and restricted pet areas in housing complexes.

The types of pet policies available are also sometimes limited by local and state laws. A typical restriction limits the type of pets permitted. For example, the town code of the Town of Islip, New York, restricts persons from keeping, harboring, or possessing a wild animal. This provision expressly disallows wild dogs, wild cats, predator birds, venomous or constricting snakes, venomous insects, and venomous lizards.

Another illustration of local regulation overriding freedom of contract is a law that renders no-pets policies waived if not enforced. New York City’s Administrative Code requires that when a tenant “openly and notoriously for a period of three months or more … harbors … household pet[s] … and the owner … has knowledge of this fact” lease provisions prohibiting animals are deemed waived. Section 27-2009.1(b). The code deems any lease provision to the contrary to be “void as against public policy.” Section 27-2009.1(c). These two examples demonstrate that
counsel must perform extensive due diligence on local laws for restrictions on housing providers prior to advising their clients of what may be included in a particular lease and what cannot be so included. Also, counsel must advise their clients of the effect of non-action following breaches of a particular pet policy clause.

Beyond laws that restrict the types of pet policies available are those that change the classification of a pet entirely, such as antidiscrimination laws. Here, using different terminology to describe certain animals may render a pet policy irrelevant regardless if it is contained within a lease. Under antidiscrimination laws, an animal’s classification may change from that of a pet to that of a treatment to a tenant’s disability. Treating animals can be subclassified as service animals, emotional support animals (ESAs), and psychiatric service animals (PSAs). In connection with landlord-tenant law, the classification of an animal as a pet, service animal, ESA, or PSA is not only relevant but also dispositive.

Currently, there are two federal statutes concerning animals in real estate: the Fair Housing Act (FHA) and the Americans with Disabilities Act (ADA). The FHA deals with housing, and the ADA deals with non-permanent housing and transient (short-term) facilities. More specifically, the FHA prohibits discrimination in the sale, rental, and financing of dwellings. In contrast, the ADA prohibits discrimination in public accommodations, including places of lodging, such as inns, hotels, and motels, and sales or rental establishments, such as shopping centers.

Different parties are held responsible for compliance under each act. With respect to the ADA, both landlords and tenants are responsible parties under the act. 28 CFR 36.201(b). The regulation permits landlords and tenants to allocate their respective responsibilities by way of their lease. Competent counsel must not only advise that such allocation is addressed, but that potential cross-claim issues are included with appropriate indemnification provisions. With respect to the FHA, real estate brokers, appraisers, property managers, mortgage loan originators, cooperative boards, sellers, landlords, and even condominium boards are responsible for complying with the law. 42 USC Chapter 45. All are prohibited from discriminating in the sale, rental, and financing of a dwelling, as well as in the making, printing, or publishing “any notice, statement, or advertisement, with respect to the sale or rental of a dwelling that indicates any preference” for those without a handicap. 42 USC 3604(c).

Surprisingly, the statutory text of both the ADA and the FHA does not include the terms animal or pet at all. Instead, each act protects a class of individuals who require the animal in order to equally use and enjoy the real estate. The ADA protects those individuals who have “disabilities” while the FHA protects those who have “handicaps.” The FHA defines a handicap as “(1) a physical or mental impairment which substantially limits one or more of such person’s major life activities, (2) a record of having such an impairment, or (3) being regarded as having such an impairment” and the ADA defines disability as “(A) a physical or mental impairment that substantially limits one or more major life activities of such individual; (B) a record of such an impairment; or (C) being regarded as having such an impairment.” 42 USC 2302(h); 42 USC 12102(1). As you can see, the definitions of handicap and disability are quite similar. Under both
discrimination is defined as the refusal or failure “to make reasonable accommodations in rules, policies, practices, or services, when such accommodations may be necessary to afford such person equal opportunity to use and enjoy a dwelling” or “goods, services, facilities, privileges, advantages, or accommodations.” See 42 USC 3604(f)(3) [FHA]; 42 USC 12182(b)(2)(A) [ADA]. The definitions of these terms give rise to animals’ place in the law, but how?

According to the Journal of Social Issues, “[p]et ownership has been studied as a direct influence on health . . . and as an influence on health in the context of other life circumstances, most notably the presence of life events.” See Judith M. Siegel: Companion Animals: In Sickness and in Health, 49 JSI 1, 157–167 (1993). Similarly, doctors have found success with “pet facilitated therapy,” a “therapeutic intervention that involves an animal” and have found that “pets … can influence physician utilization among the elderly.”

Bringing these concepts together, if a person is handicapped, pursuant to the FHA, in terms of having stress, for example, and their healthcare provider recommends pet-facilitated therapy, is it not a reasonable accommodation for the housing provider to be required to permit the pet in order to enable the handicapped person equal opportunity to use and enjoy a dwelling? That is how the FHA is currently interpreted. The U.S. Department of Housing and Urban Development (HUD), which administers the FHA, has set forth a pet-friendly policy, which expressly permits both animals that require training (e.g., service animals and PSAs) and those that do not (e.g., ESAs) in housing. See “Pet Ownership for the Elderly and Persons With Disabilities; Final Rule” at 24 CFR Part 5. Additionally, HUD provides a sample prescription form for ESAs to be utilized by prescribing healthcare professionals.

The case law also speaks to ESAs in housing where a reasonable accommodation is requested pursuant to the FHA. See Falin v. Condominium Ass'n of La Mer Estates, 2012 US Dist LEXIS 73453, 1 (S.D. Fla. May 28, 2012). In Falin, the plaintiff attempted to buy two rental units for himself and his 95-year-old mother, who suffered from dementia and related handicaps, but was barred because his mother had a three-pound Chihuahua, which allegedly provided emotional support. The court held that an ESA may be a reasonable accommodation under the FHA when the animal is necessary for a disabled person to enjoy equal housing rights. Similarly, the U.S. District Court for the Southern District of Ohio, in Overlook Mut. Homes, Inc. v. Spencer, addressed the issue of a dog to treat an anxiety disorder and held that the FHA contains no training requirement to raise a standard pet to an ESA. See 666 FSupp2d 850 (S.D. Ohio 2009).

In contrast, the ADA does not recognize ESAs. The U.S. Department of Justice, which administers the ADA, issued revised regulations stating that, as of March 15, 2011, only dogs are recognized as service animals under the ADA and such a service animal must be individually trained to do work or perform tasks for the disabled person to qualify. Nonetheless, the ADA does recognize PSAs, as held by the U.S. District Court for the Eastern District of New York in Stamm v. New York City Transit Authority. See 42 NDLR P 278 (E.D. NY 2011). The court in Stamm looked to the “Notice of Proposed Rulemaking (‘NPRM’)” issued by the DOJ in
connection with proposed changes to … that agency’s definition of ‘service animals’” and specifically to its language, which states:

[PSAs] can be trained to perform a variety of tasks that assist individuals with disabilities to detect the onset of psychiatric episodes and ameliorate their effects. Tasks performed by [PSAs] may include reminding the handler to take medicine; providing safety checks, or room searches, or turning on lights for persons with Post Traumatic Stress Disorder; interrupting self-mutilation by persons with dissociative identity disorders; and keeping disoriented individuals from danger.

Thus, PSAs are differentiated from ESAs on the basis of how they assist their owner, not by the precise disability had by the specific individual within the protected class.

In conclusion, how an animal is classified—as a pet, service animal, ESA, or PSA—can have significant implications under the law. This is the juggernaut that spurs litigation in this legal field. How should a real estate professional address the presence of an animal on their real property? Pursuant to the Joint Statement of the Department of Housing and Urban Development and the Department of Justice on Reasonable Accommodations under the Fair Housing Act, “If a person’s disability is obvious, or otherwise known to the provider, and if the need for the requested accommodation is also readily apparent or known, then the provider may not request any additional information about the requester’s disability or the disability-related need for the accommodation.” Further, “if the requester’s disability is known or readily apparent to the provider, but the need for the accommodation is not readily apparent or known, the provider may request only information that is necessary to evaluate the disability-related need for the accommodation.” For a provider to inquire further exposes him or her to liability under the ADA and FHA. See Bhogaita v. Altamonte Heights Condominium Association Inc., 2012 U.S. Dist. LEXIS 178183 (M.D. Fla 2012).

As a result, counsel must be proactive in crafting pet policies that provide reasonable accommodations for service animals, PSAs, and ESAs. They must also address typical concerns about pets, such as damage to units. Today, blanket rules for animals on real property should not exist. Instead, real estate owners should offer their staff a taxonomy training to address each uniquely situated person who enters their property. Otherwise, it’s a matter of time before litigation is threatened or ensues.

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Seventh Circuit Takes a Second Look at CERCLA Liability after EPA Settlement

By Jessica Wall and Travis Godwin

In a rare amended decision, the Seventh Circuit has added yet more wrinkles to an already crag-filled area of the law: when parties who have settled their liability with the Environmental Protection Agency can bring claims for contribution, versus claims for cost-recovery, under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). The court’s original decision in Bernstein v. Bankert, 733 F.3d 190 (7th Cir. 2013) (dated December 19, 2012) caused such concern regarding the liability of potentially responsible parties (PRPs) upon settlement with the EPA that the EPA felt compelled to join the defendant-appellants as amicus curiae urging rehearing of the case by a panel. The Seventh Circuit issued its amended decision on July 31, 2013.

In Bernstein, the trustees of a fund created to finance and oversee the cleanup of a former waste-handling and disposal site incurred significant costs in undertaking removal actions at the site. The trustees entered into two administrative orders by consent (AOCs) with the EPA, one in 1999 and another in 2002, forcing such removal actions. The EPA approved the work completed under the 1999 AOC in October 2000. In 2008, the trustees brought several claims, including a cost recovery claim under CERCLA § 107(a), against the former owners of the site, their corporate entities, and their insurers. When the trustees filed suit, the work under the 2002 AOC remained unfinished, and the EPA had not deemed it completed.

CERCLA § 107(a) grants an “any person” a cause of action to sue a PRP for cleanup costs incurred in a removal or remedial action. CERCLA § 113(f), by contrast, provides causes of action for PRPs to recover response costs from other PRPs.

The trial court held that the trustees could not bring a CERCLA cost recovery claim under § 107(a) because the trustees did not voluntarily clean up the site when they entered the 1999 and 2002 AOCs. Rather, the trustees’ claim was properly construed as one for contribution under CERCLA § 113(f) because the 1999 and 2002 consent orders required the trustees to undertake removal actions. The trial court further found that the statute of limitations under § 113(f) had run and thus the trustees’ CERCLA claims failed.

On appeal, the Seventh Circuit found in its original December 2012 opinion that whether CERCLA claims were available to the trustees turned on the difference between the 1999 AOC and the 2002 AOC. Both AOCs contained language specifying that the trustees were not released from CERCLA liability until the trustees performed their obligations under the AOC completely and satisfactorily. Because the trustees had completed their work under the 1999 AOC, they had resolved their liability to the United States. After analyzing CERCLA’s statutory construction—as well as case law in the Second, Third, Fifth, Sixth, Eighth, and Eleventh Circuits—the Seventh Circuit held that the trustees could not bring a cost recovery claim under § 107(a)
because “a plaintiff is limited to a contribution remedy when one is available.” As a result, the only CERCLA claim available to the trustees for the costs incurred per the 1999 AOC was a contribution action under § 113(f). The statute barred that action because more than three years had elapsed since either the effective date of the AOC or the completion of the work done pursuant to it.

By contrast, because the trustees had not yet completed the work under the 2002 AOC, and the EPA had not yet approved the completed work, the court determined that the trustees had not resolved their liability to the United States as understood under CERCLA. The court wrote

To the extent that the Trustees’ suit seeks to recover expenses arising out of their performance of the 2002 AOC, it is not a contribution action. The Trustees have been subjected to no civil action under [CERCLA §§ 106 or 107], so a contribution action under [CERCLA§ 113(f)(1)] is unavailable. On the other hand, under the plain terms of the AOC, they could not have ‘resolved [their] liability to the United States ... for some or all of [the work performed under the 2002 AOC] or for some or all of the costs of [the work performed under the 2002 AOC] in an administrative ... settlement’ at any time before satisfactory discharge of their obligations under the 2002 AOC. Since the work to be performed under the 2002 AOC was ongoing when this action was filed, and no notice of approval had issued which would trigger the conditional covenants not to sue, a contribution action under [CERCLA § 113(f)(3)(B)] is likewise unavailable. What the Trustees have done, with respect to the work called for by the 2002 AOC, is incur costs of response consistent with the national contingency plan, as is required to file a cost recovery action under [CERCLA § 107(a)].

Thus, because the work under the 2002 AOC was ongoing when the trustees filed suit, and the trustees’ liability was still unresolved, the trustees could not bring a contribution action under § 113(f). Instead, because the trustees incurred response costs, their claim was properly construed as a cost recovery action under § 107(a).

The 2012 Bernstein decision gave rise to concern in the environmental law community, especially from the EPA. Chief among the EPA’s concerns was whether Bernstein’s holding suggested that a party may never structure a settlement agreement with the EPA to resolve liability upon execution of the agreement rather than upon completion of its requirements.

The Seventh Circuit amended its decision in July 2013 to address those concerns. First, the defendants below argued that the 2012 decision should be revisited because an AOC “compels” a PRP to incur costs; thus, a party may recover those “compelled” costs in a contribution action. The Seventh Circuit rejected this argument as an inaccurate reading of Supreme Court precedent in United States v. Atlantic Research Corp., 551 U.S. 128, 139 (2007). Second, the court discussed the argument advanced by both parties, that entering into a settlement agreement with the EPA resolves liability under CERCLA. Here, the Seventh Circuit rejected the EPA’s statutory interpretation, and wrote, “[t]o meet the statutory trigger for a contribution action under § 9613(f)(3)(B), the nature, extent, or amount of a PRP’s liability must be decided, determined,
or settled, at least in part, by way of agreement with EPA.” The court followed the plain meaning of the language of the AOC and found that the trustees did not resolve liability by entering into the 2002 AOC with the EPA. Finally, the court addressed the policy considerations at stake, namely, that PRPs will be discouraged from settling with the EPA quickly if entering into a settlement does not resolve a PRP’s liability. The court found these policy considerations unpersuasive and noted that although a settling PRP may not sue a nonsettling PRP until the settling PRP’s liability is resolved, that settling PRP may pursue a cost recovery action. The court added, “whether, and when, a given settlement ‘resolves’ a party’s liability to the EPA for purposes of [contribution under § 113(f)] is ultimately a case-specific question dependent on the terms of the settlement before the court.”

From a practical perspective, Bernstein reminds practitioners to consider their settlement options and language closely. On one hand, a conditional settlement similar to the trustees’ 2002 AOC (one that does not decide, determine, or settle the nature, extent, or amount of a PRP’s liability immediately upon signature) benefits a PRP by providing a cost recovery action with a longer statute of limitations, joint and several liability, and recovery against PRPs who have settled with the EPA. On the other hand, a final settlement (one that decides, determines, or settles the nature, extent, or amount of a PRP’s liability immediately) benefits a PRP by resolving its liability with the government, resolving the threat of an enforcement suit, and protecting the PRP from contribution actions from other parties. However, a final settlement will make only a contribution claim available to a PRP, and the statute of limitations begins to run from the date of settlement. In addition, because whether a settlement “resolves” liability is a case-specific question, practitioners should scrutinize provisions similar to those in the Bernstein AOCs carefully to evaluate potential suit options going forward.

Following Bernstein, many practitioners are still criticizing even the amended decision as it leaves open the question of what happens when a PRP has fulfilled its settlement obligations to the EPA, but cost recovery litigation remains pending. One could read Bernstein to hold that, at least in in the Seventh Circuit, such an action must be dismissed and reconfigured as a contribution claim.

On October 29, 2013, the former owners of the site filed a petition for a writ of certiorari in the Supreme Court. Soon, the Supreme Court may take the opportunity to clarify the holding, rationale, and implications of the Seventh Circuit’s opinion in Bernstein. If so, we’ll keep you posted.

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NY Department of State Tightens Rules on Job Titles
By John A. Snyder and Michael Taxin

The common practice of commercial and residential real estate agents in New York using fancier titles such as “president,” “vice president,” “managing director,” and “executive vice president” is subject to heightened scrutiny as a result of two recent letters from the New York Department of State (DOS) that give notice that use of such titles may be dishonest or misleading advertising and subject to penalty. In response to these opinion letters, companies must exercise due care when giving titles to brokers, associate brokers, or salespersons (known collectively as “agents”), whether they are affiliated with their brokerage firms as independent contractors or employees, and in preparing marketing or advertising material, such as business cards, show sheets, press packets, deal sheets, web sites, email auto-signatures, and social media.

The April Opinion Letter
On April 26, 2013, the DOS opined that a brokerage may not permit an agent to use the titles president, vice president, senior vice president, executive vice president, or managing director for marketing purposes unless the agent is, in fact, an officer or director of the brokerage company. The department noted that Section 441-c(1)(a) of the New York Real Property Law subjects an agent to potential suspension or revocation of his or her license; a fine not exceeding $1,000; or reprimand, if the agent is found to have engaged in “dishonest or misleading advertising” and that the use of such titles by noncorporate officers violates this statute.

The DOS applied a common meaning standard to “dishonest or misleading advertising” in its opinion letter because the phrase is undefined by the statute and implementing regulations. In doing so, the department looked to New York’s Business Corporation Law and determined that a brokerage’s use of a corporate title for agents suggests that the brokerage company has officially elected or appointed the agents as officers under applicable corporate law, capable of making decisions for and binding the company and managing the daily business of the company. Therefore, an agent who is not a corporate officer who holds himself or herself out with a corporate title is engaging in dishonest or misleading advertising “because doing so would lead the public to believe that the brokerage entity has appointed or elected the Agent as an officer or to a comparable management position.”

Next, the DOS stated that even if a brokerage has taken action to officially appoint or elect an agent as a corporate officer, any such action would need to comply with another New York requirement that prohibits the ownership of voting stock by salespersons and associate brokers (subordinate licensees) in 19 NYCRR 175.22 and N.Y. McKinney’s Real Property Law §441-b(2). Read together, these provisions prevent a subordinate licensee from holding voting stock or being appointed as an officer in a corporate brokerage company, a manager or member of a limited liability company, or a member of a partnership. Consequently, only brokers licensed as company brokers—those who supervise subordinate licensees and are made officers of the brokerage consistent with corporate law—can use titles such as managing director or vice
president or similar titles suggestive of a corporate officer of management position. Subordinate licensees cannot use such titles.

The August Opinion Letter
In a second opinion letter, issued August 20, 2013, the DOS clarified several issues from its first opinion letter. The DOS first explained that a subordinate licensee cannot become an officer in a corporate brokerage, a manager or member of a limited liability company, or a member of a partnership unless he or she upgrades his or her license (really a reapplication) to that of a “broker” and acts as a company broker, meaning their license is not held underneath another individual “broker.” According to the second opinion letter, the rationale behind this restriction derives from the division of responsibilities between brokers and subordinate licensees. Citing N.Y. McKinney’s Real Property Law §440(5) and 19 NYCRR 175.2, the DOS stated that brokers are responsible for the conduct of the corporate brokerage and required to guide, instruct, oversee, and supervise the actions of subordinate licensees, while subordinate licensees are prohibited from running the daily operations of the brokerage or holding shares of voting stock.

The DOS also clarified whether a subordinate licensee may be appointed as a “director” of a brokerage corporation. Because the term director is not well defined under Real Property Law §441-b(2), the DOS looked to its general meaning under corporate law. Under New York Business Corporation Law §102(a)(5), a director is defined as “any member of the governing board of a corporation, whether designated as director, trustee, manager, governor, or by any other title.” A director assists in the business of managing the corporation as a member of a corporate board of directors. See Business Corporation Law §701. Given that a subordinate licensee is not permitted to participate in the management of a corporate brokerage, a subordinate licensee may not serve as a director.

Third, the letter clarified that a subordinate licensee who is an employee of the brokerage, rather than an independent contractor, may not hold a corporate officer position. Article 12-A of the Real Property Law does not recognize a distinction on the basis of independent contractor versus employee status. Relying on a prior opinion letter, the department stated that, at heart, the relationship between a broker and salesperson is that of principal and agent, even though the Internal Revenue Code allows for such salespeople to be treated as independent contractors. 26 U.S.C. § 3508. A broker (principal) is legally accountable for the acts of a salesperson or associate broker who is licensed with, by, or underneath that broker, even if such person is classified as an independent contractor.

Finally, the second opinion letter makes clear that Article 12-A does not prohibit the issuance of all titles to subordinate licensees. The DOS said Article 12-A only prohibits false and misleading advertising and prohibits a subordinate licensee from using a title that would mislead the public into thinking that the subordinate licensee is a corporate officer (or other elected position) of the brokerage company when he or she is not. Titles that imply that a subordinate licensee is involved in the management, supervision, and/or control of the brokerage company are false,
misleading—and prohibited. Titles that do not reasonably lead to such implications or other descriptions of success or experience are permitted, as long as they are truthful and accurate.

These two opinion letters from the DOS have resulted in wholesale changes to the way the New York real estate industry—which, according to the Wall Street Journal, consists of 52,736 licensed real estate brokers and 57,347 salespersons—refers to its subordinate licensees, with only “brokers” being permitted to retain titles that signify corporate officership. As a result, business cards, vCards, and other promotional material are being modified and existing materials are being thrown in the trash bin. Going forward, to avoid potential pitfalls, including fines or license suspension and revocation, serious thought must be given to whether to keep existing titles, as well as whether to confer titles on new agents in New York, and companies must closely monitor the titles used in their external communications, social media, and advertising and marketing materials. It is widely expected that the state will begin enforcing these rules in 2014.

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Phase I Standard Gets a Facelift
By Samantha Corson and Kyle Johnson

Parties on both sides of a real estate transaction depend on the Standards and Practices for All Appropriate Inquiries in conducting Phase I Environmental Site Assessments for preacquisition due diligence that allow a party to assert the innocent purchaser, bona fide prospective purchaser, and contiguous property owner defenses to CERCLA liability. However, the underlying standard, ASTM International’s E1527-05 “Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process,” has been applied differently in practice, leading to wide dissimilarities in the manner in which environmental consultants conducting Phase I assessments identified certain conditions, such as vapor intrusion and historical contamination. As a result, the intended standardization and reliability of the Phase I inquiry and the protections that flow from it have become less dependable, undermining the standard’s purpose. For these reasons, real estate practitioners familiar with these pitfalls are optimistic and changes to ASTM’s E1527-05 standard will return that reliability and continuity that parties to real estate transactions seek.

ASTM International published E1527-05 in 2005. Shortly thereafter, it was adopted by the U.S. Environmental Protection Agency as the rule that sets forth the Standards and Practices for All Appropriate Inquiries (AAI rule) that a party must use to satisfy the requirements for conducting “all appropriate inquiries” under Section 101(35)(B) the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). In accordance with ASTM’s general practice of updating standards every eight years, a new E1527 standard has now been finalized and issued by ASTM. The new version of E1527 revises many of the provisions that have led to confusion in the past. The Environmental Protection Agency (EPA) reportedly hopes to complete its process to reference the revised standard as compliant with AAI by the end of 2013.

Time for a Change
The revised standard makes many editorial changes but also makes several changes that will impact the content of Phase I environmental site assessments. These include revisions to certain defined terms that will change the way risk-based closures are reported and, to clarify the relevance of current regulatory criteria, includes an explicit requirement to consider vapor intrusion and an increased focus on regulatory file reviews.

Risk-based and historical closures The new E1527-13 includes a revision to the definition of the term “Historical Recognized Environmental Condition” (HREC) and the introduction of a new term, “Controlled Recognized Environmental Condition.” Both changes are intended to ensure that activity and use limitations (AULs) and engineering controls are reported in a Phase I report and to clarify where regulatory requirements have changed such that a past release that was remediated should nonetheless be considered a recognized environmental condition (REC) due to a change in regulatory standards since the remediation was completed.

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**Changes to HREC definition** The definition of HREC has been modified to apply only to historic releases that have been remediated to unrestricted use. Under E1527-05, HREC was defined as an environmental condition that would have been considered a REC but due to remediation or other corrective action is no longer considered a REC. The new HREC definition pertains to past releases that have been addressed to the satisfaction of regulatory authorities or meeting unrestricted residential use criteria, without subjecting the property to any property use restrictions, AULs, or other engineering or institutional controls. The new definition also requires the consultant conducting the Phase I assessment (known as an “environmental professional”) to evaluate whether the past release would now be considered a REC due to, for example, changes in regulatory criteria in the applicable jurisdiction. In other words, releases that may have been adequately addressed in the past may be called RECs due to changes in the acceptable cleanup criteria for a particular contaminant. Although some environmental professionals conducted this exercise under the prior standard, it will now be a mandatory step. This further scrutiny of past releases is more likely to be a concern in states where cleanup standards are revised on a somewhat frequent basis.

**A new defined term: the CREC** Following logically from the revised definition of HREC is the addition of a new term, the Controlled Recognized Environmental Condition (CREC), which describes environmental conditions that have been addressed to the satisfaction of a regulatory authority but where residual contamination has been allowed to remain in place subject to the implementation of property use restrictions, AULs, or other institutional or engineering controls. Strangely, the new definition requires that the condition be identified as a CREC in the findings of the report but as a REC in the conclusions section.

The practical impact of the addition of the CREC (and the revisions to the HREC) term may be an increase in the number of conditions (RECs, HRECs, and CRECs) highlighted in a Phase I report. Although arguably conditions now characterized as CRECs should have been characterized as RECs under E1527-05, environmental professionals’ reporting of such conditions in the past was inconsistent. Under the updated standard, Phase I reports will have a renewed emphasis on AULs and other controls. For real estate lawyers, highlighting of such controls will increase the likelihood that a new owner of property will better understand the on-going maintenance responsibilities that may come with a site that is subject to a CREC. The focus on risk-based remediation distinctions may also result in a greater emphasis in Phase I reports on the intended end-use of the property. As such, it will be important for lawyers involved in these transactions to confirm that the environmental professional conducting a Phase I report understands the key drivers for the transaction, including the parties’ respective materiality thresholds and proposed use for the site.

**A New Focus on Vapor Intrusion**
Perhaps the most significant change to the E1527 standard is the introduction of language throughout the standard to clarify that vapor migration should be considered in the Phase I report. Vapor intrusion was not specifically addressed under E1527-05, except that “indoor air quality” was expressly identified as a “non-scope consideration” that did not need to be considered or addressed in the report. This language likely was intended to acknowledge that many indoor air quality issues are outside the scope of CERCLA liability. For example, CERCLA liability typically does not attach to conditions caused by naturally occurring substances such as radon or mold and does not apply to the presence of asbestos-containing building materials at a building on a site. Similarly, workplace exposure and OSHA-type issues are not appropriately considered in the context of determining compliance with all appropriate inquiries. Finally, the exclusion of indoor air quality issues may have been an implicit acknowledgement that ASTM has a separate standard that relates to “vapor encroachment screening,” described in ASTM E2600-10, that is intended to provide a practical guide for vapor screening. Nevertheless, courts and commentators generally agree that CERCLA’s emphasis on releases of hazardous substances is not limited to hazardous substances in solid and liquid forms. Thus, the potential for vapor intrusion caused by a release of hazardous substances should be evaluated by all environmental professionals conducting Phase I assessments. Unfortunately, the express identification of “indoor air quality” as a non-scope consideration in E1527-05 was misleading in that it implied that vapor intrusion issues did not need to be investigated to satisfy the CERCLA AAI Rule. In practice, many environmental professionals skipped this step.

The revised E1527-13 standard includes language explaining that vapor should be part of the Phase I environmental assessment. Section 2.1 of the revised rule states that vapor migration should not be considered differently than groundwater migration and references ASTM’s E2600-10 as the preferred methodology for assessing vapor issues. Other portions of the revised standard now also reference vapor, including the definition of AULs. Lastly, the reference to indoor air quality, which was previously listed as a non-scope consideration, now includes language that clarifies that only indoor air quality issues unrelated to releases of hazardous substances or petroleum products are non-scope items. Now that the scope of the standard has been clarified to expressly include vapor intrusion issues caused by releases of hazardous substances, we can expect that Phase I reports will identify potential vapor intrusion issues more frequently than was typical under the old ASTM E1527-05 standard.

**Regulatory agency file review** The third significant change in the ASTM E1527 standard relates to the environmental professional’s need to conduct agency file review. A new provision of the E1527 standard, Section 8.2.2, states that if the subject property or an adjoining property are identified in a government records search (i.e., an EDR database search), then the environmental professional, at his or her discretion, should review the pertinent regulatory files or records associated with that listing. If such a review is deemed unwarranted, the environmental professional must expressly justify the decision not to conduct the search. File reviews can be beneficial in giving further color about certain listings that would otherwise be incomplete. For example, further detail on a historical release that may simply be identified as “closed” on a database listing but a
file review can reveal additional important details about the regulatory status of a release and whether AULs or other controls are in place. The likely impact of these edits will be an increased use of file reviews, potentially raising the cost to complete and lengthening the time needed to finalize the Phase I report.

**Negative Comments Result in Delays to the AAI Rule**

The updates to the ASTM E1527 standard should go a long way toward minimizing some of the inconsistencies in the ways that environmental professionals conduct Phase I environmental site assessments (most significantly in the treatment of risk-based closures and vapor intrusion). However, EPA's adoption of the standard as an amendment to the AAI rule has been delayed due to feedback EPA received during the public comment process.

EPA initially published the proposed amendments to the AAI rule to reference the updated ASTM E1527-13 standard as a “direct final rule” under the assumption that the revisions were mostly editorial in nature and that there was unlikely to be any negative comments (see 78 Fed. Reg. 49690 (Aug. 15, 2013)). Under the original timeframe, the direct final rule was expected to take effect in November 2013. However, the EPA received a number of negative comments to the direct final rule and has therefore withdrawn it. The comments received are being treated as having been submitted in response to a parallel proposed rule (78 Fed. Reg. 49714 (Aug. 15, 2013)).

The negative comments primarily focused on the preamble to the AAI rule rather than the direct final rule itself. Specifically, the negative comments keyed in on the EPA’s recognition in the preamble that “there are no legally significant differences” between the ASTM E1527-05 and ASTM E1527-13 standards and, as such, any party conducting all appropriate inquiries may choose to use either standard. As the E1527-13 standard is likely to be more costly than the older standard, commenters suggested that allowing both standards would “create chaos and confusion in the marketplace” and a two-tier diligence market with “cost-sensitive” users applying the E1527-05 standard.

In response, other commenters noted that the two-tier marketplace is a “phantom threat” and that a two-tier marketplace has not emerged with other ASTM standards, including in 2005 when the E1527-05 standard replaced the 2000 standard. Such commentators have concluded that the E1527-05 standard will simply retire from common practice once the E1527-13 standard is published and the latter would become the industry standard. Moreover, the reference to the older standard ensures that properties that were assessed over the past eight years under E1527-05 remain compliant with the AAI rule.

As noted, the negative comments focus on the preamble to the AAI rule. Consequently, while the EPA must withdraw the direct final rule and address the comments, the content of the rule is unlikely to be changed. As of November 6, 2013, the revised standard has been published by ASTM and simply awaits EPA publication of the amendment, which references the new standard as compliant with all appropriate inquiries.
Samantha Corson and Kyle Johnson are attorneys Greenberg Traurig LLP in Philadelphia, Pennsylvania.
Mind the Gap Between Market Value and Expected Proceeds
By Scott Fowler, Trevor Phillips, and Steven Laposa

Passengers traveling on the London Underground are famously cautioned to “mind the gap” that exists between the train’s door and the station platform. Real estate attorneys, lenders, and experts are warned to “mind the gap” of a different sort when engaged in litigation involving distressed commercial real estate, such as bankruptcy or foreclosure proceedings. In this context, the gap is the difference between the appraised market value and the proceeds or sales price that can be reasonably expected in a disposition of the asset under distress conditions. It varies by asset type and market; the gap may be minimal for high-demand core assets attracting institutional money in strong markets, or the gap may be highly significant for assets such as vacant land in overdeveloped markets.

Market value is usually based on the passing of title from seller to buyer under conditions where (1) the buyer and seller are typically motivated; (2) both parties are well informed and acting in what they consider their own best interests; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in cash or in equivalent financial arrangements; and (5) the price represents the normal consideration for the property, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

These five conditions of market value often do not hold for distressed commercial real estate assets due to uncertain economic conditions, unstable capital markets, and other factors. Rather, distressed market conditions can create an environment in which an asset’s sale price may be significantly less than the appraiser’s opinion of market value using the above definition. Why is this important? Establishing the actual cash value (expected monetary proceeds) of distressed commercial real estate assets is essential for estimating damages (if any), securing a new loan, developing a plan of reorganization, or a variety of other reasons. If future actions or decisions rely on knowing the likely sale price, variances from market value must be analyzed and understood.

Origin of the Gap
The gap is created by a disconnect between the factors typically considered in estimating market value and those that actually exist for a troubled asset in a bankruptcy, foreclosure, or litigation setting. For example:

- There is often a stigma associated with troubled assets, especially those in a foreclosure or bankruptcy setting where a financial institution may end up with control of the asset. Although the appraiser correctly assumes that the sale is consummated based on typical market terms, buyers have been conditioned to expect a discount when purchasing troubled assets and thus expect to pay less than the appraised market value.
- Appraisals in hand at the onset of distress conditions are likely based on assumptions (rent growth or vacancy forecasts) that are expected to occur under normal market conditions. These may be realistic assumptions and correctly mirror market expectations,
but investors base their purchasing decisions on current market conditions and seller circumstances, with no consideration given to an improving market. They consider the upside to be their reward (and risk mitigation) for investing in a distressed asset in an uncertain market.

- Distress conditions often affect entire portfolios of assets. If, for instance, conditions require a sale of a portfolio of assets, an abundance of supply, unanticipated in individual appraisals, may enter the market at once putting downward pressure on prices as increased supply is introduced to a limited pool of buyers. Bulk discounts must be considered if a portfolio of assets will likely be sold in large quantity to a limited number of buyers.
- Marketing times associated with a disposition may be limited under foreclosure, bankruptcy, or litigation scenarios. This may make the proceeds ultimately received from a sale closer to a liquidation value.
- Costs associated with litigation will have an impact on the ultimate proceeds received from a disposition. As an example, many financial institutions assume a 10 percent reduction in appraised value for litigation fees, selling expenses, and other troubled asset costs.

**Determining the Size of the Gap**

“Mind the gap” will likely be echoing throughout the commercial real estate industry for the foreseeable future. As a result, lenders, investors, owners, and their counsel need to identify and quantify this difference between market values and expected sales prices in order to have a realistic basis for decision making in distressed market conditions. Although the level of troubled commercial real estate assets has stabilized over the past several years, the data show that the issue is not likely to diminish in the future. According to [Real Capital Analytics](#), there was a total of $148.3 billion of U.S. commercial mortgages classified as distressed as of second quarter of 2013. Some of the highest levels of REO mortgages included office ($12.5 billion), multifamily ($9.4 billion), and development sites and others ($8.6 billion).

The gap is not only evident in the United States; international markets are also plagued by discounted bulk sales of non performing loan portfolios and commercial mortgage-backed securities workouts. Lloyds Bank recently sold an 850-million-euro German loan portfolio to the U.S. hedge fund Marathon Asset Management for 400 million euros, and subsequent to the privatization of the Dutch bank SNS Reaal, which held 8.4 billion euros in real estate loans, large differences were discovered between the bank’s internal valuations provided to external auditors and separately prepared independent appraisals that took account of distress conditions. This is similar to the United States, where financial institutions carry assets at appraisal values that are significantly higher than offers they receive for the property. Real Capital Analytics reports that recovery rates of liquidated default commercial mortgages during 2012 ranged from 66 to 70 percent. *Id.* Debt downgrades and non performing loan sales will continue to have an impact on buyers’ perceptions of market values that may not be reflected in sales comparables used in appraisals.
It is important to note that measuring the gap by analyzing only transactions is likely to underestimate the true size of the gap. Assets that have not been sold likely remain on the books of financial institutions or in the portfolios of borrowers because lower sale prices result in deterioration of capital ratios leading to regulatory scrutiny for lenders or loan covenant violations for borrowers. These assets would likely receive the steepest discounts; thus, if they were actually sold, the average gap would widen.

The table below compares the five conditions of market value on which most appraisals are based with conditions associated with distressed assets and how those conditions may affect the proceeds from an eventual sale—the gap.

**Normal vs. Distress Conditions**

<table>
<thead>
<tr>
<th>Normal Market Conditions</th>
<th>Distress Conditions</th>
<th>The “Gap”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyer and seller are typically motivated.</td>
<td>The buyer is acting prudently and knowledgeably, but the seller is under extreme compulsion to sell.</td>
<td>Buyers “expect” a below-market deal, and the seller has limited power to negotiate.</td>
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<tr>
<td>Both parties are well informed or well advised, and each is acting in what he or she considers his or her own best interests.</td>
<td>The buyer is typically motivated and acting in his or her best interest. The seller may be forced to complete a transaction he or she normally would not under normal market conditions.</td>
<td>The seller often has to take the best deal available, which is often well below appraised value.</td>
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<td>A reasonable time is allowed for exposure in the open market.</td>
<td>Marketing periods will differ, but often times the seller is not afforded the opportunity or time to muddle through a bad market and is forced to sell under less than ideal conditions, similar to a liquidation scenario. The buyer realizes it may take time for the market to turn and thus applies further</td>
<td>A more rapid sale is generally achieved at a price lower than market value, often reflecting proceeds closer to a liquidation price.</td>
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<tr>
<td><strong>Discounts to Minimize the Risk Associated with an Extended Holding Period.</strong></td>
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<tr>
<td><strong>Payment is Made in Terms of Cash in U.S. Dollars or in Terms of Comparable Financial Arrangements.</strong></td>
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<tr>
<td><strong>No Significant Differences</strong></td>
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<tr>
<td><strong>Minimal Impact</strong></td>
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<tr>
<td><strong>The Price Represents the Normal Consideration for the Property Sold Unaffected by Special or Creative Financing or Sales Concessions Granted by Anyone Associated with the Sale.</strong></td>
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<tr>
<td><strong>Some Distressed Assets Have Creative Financing That is Not Typical of Market Terms.</strong></td>
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<tr>
<td><strong>If Creative Financing Exists, It Must Be Fully Understood and Addressed. For Example, in Bankruptcy Scenarios, Interest Rates May Be Set Significantly Below Market in Reorganization Plans.</strong></td>
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**Bridging the Gap**
A significant gap can have serious implications if unattainable values are used to develop legal or investment strategies for resolving or working through distress conditions. Although it may not be feasible to actually close the gap between expected sale prices and appraised values, it may be possible to understand and bridge the gap through the correct application of accurate empirical data, sound market analysis tools and models, and reasonable steps to identify and challenge critical assumptions within appraisals. These steps are relevant for individual properties as well as portfolios of properties. As the saying goes, knowledge is power. So how do attorneys, lenders, and their experts bridge the gap between appraised values and distressed sale prices? Are there systematic steps one can follow to determine whether a gap exists and, if so, how to reconcile?

The analysis should begin by identifying and quantifying any effects attributable to significant changes in market conditions and property-specific conditions that may have occurred since the effective date of the appraisal report. First, if the appraisal does not reflect the distressed market conditions as outlined in the table above, then the gap will most assuredly exist. Attorneys, lenders, and their experts can identify and address the gap through systematic due diligence to determine a realistic expectation of sale proceeds, such as by taking the following steps:
• Determine the completeness of the appraisal report, including the adequacy and relevance of the data used and the propriety of any adjustments to the data.
• Discuss the asset with market participants. Members of a financial institution’s special assets group will have an opinion of an asset’s reasonably expected sale price. It is likely that they continuously receive offers that they do not accept for assets they hold on their books. Although these data are not available when analyzing closed transactions, understanding where an asset may trade is critical if a sale is required. Likewise, local brokers and investors will have well-informed opinions regarding the price at which a transaction is likely to occur.
• Review the appropriateness of the appraisal methods and techniques used and challenge and confirm whether the analyses, opinions, and conclusions in the appraisal report are appropriate and reasonable (using, to begin with, the information in the table above).
• Compare the most recent rent roll, leases, or lease abstracts to the rent roll in the appraisal report and quantify any difference.
• Confirm market- and property-specific assumptions used in the appraisal report, including market rent estimates, rental rate growth, anticipated absorption levels, expense estimates, growth rates, tenant improvements, and leasing commissions; compare these assumptions with current market data and actual property performance.
• Compare going-in and terminal overall capitalization rates and yield/discount rates used in the appraisal report with current investor expectations and quantify any impact on value.
• Update the appraisal analysis with current property conditions, additional market data, and consideration of the most likely investor/purchasers active in the market and their expected rates of return, when such information is available and relevant.
• Measure the impact all of the above may have on price to develop a well-informed opinion as to whether an asset will actually trade and, if so, when it would likely trade and the proceeds that could reasonably be expected.

Conclusion
Regardless of market- or property-specific conditions, the real estate industry recognizes the existence of the gap between appraised values and sale proceeds associated with distressed assets. In fact, the definition of market value almost guarantees the presence of a gap due to the stress placed on the seller and the altered expectations of the buyer. Sometimes the gap exists because of asset bubbles, irrational pricing, and transaction volumes. Alternatively, the gap may exist because of uncertainty in the market due to recessions, declining credit market flows, or investor sentiments towards real estate. If time permits, and if appropriate to the circumstances, it may be advisable to commission a current liquidation value appraisal as a basis for decision-making. Irrespective of the reason for the gap, attorneys, lenders, investors, and other market participants are well advised to understand and quantify the gap in order to navigate the market with realistic expectations.

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NEWS & DEVELOPMENTS

Supreme Court Rules in Fannie Mae-Freddie Mac Case

The U.S. Supreme Court recently refused to permit non-party banks accused of violating federal and state securities laws in connection with the purchase of billions of dollars of residential mortgage-backed securities by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) between 2005 and 2007 to intervene in a test case against another bank, thereby preserving a decision of the U.S. Court of Appeals for the Second Circuit in favor of the Federal Housing Finance Agency (FHFA).

In July 2011, the FHFA, as conservator of Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008 (HERA), filed suit against UBS Americas, Inc., and related defendants. As amended, the complaint asserted violations of, inter alia, the Securities Act of 1933 and state securities statutes. The claims were based on allegations that Fannie Mae and Freddie Mac suffered substantial losses on their mortgage-backed securities caused by UBS’s material misrepresentations regarding the creditworthiness of borrowers and the underwriting standards of home loans serving as collateral for those investment vehicles.

In September 2011, the FHFA brought 17 similar suits against additional banks, including Citigroup, Inc., General Electric Co., and JPMorgan Chase & Co. Ultimately, 16 cases, including the UBS action, were assigned to the Hon. Denise L. Cote in the U.S. District Court for the Southern District of New York. The UBS action was eventually designated as a test case for the resolution of common grounds for dismissal motions, such that any rulings would apply to all banks.

UBS then moved to dismiss, arguing primarily that the securities claims were untimely. The District Court rejected this argument in a pair of opinions issued in May and June 2012. The Second Circuit affirmed in April 2013, holding that HERA’s extender statute of limitations applied to securities claims brought by the FHFA as conservator, and concluding that the securities claims were timely brought within the three-year period after the appointment of the FHFA as conservator. In July 2013, UBS settled its case with the FHFA.

The remaining banks moved to intervene to file a petition for a writ of certiorari, on the basis that the Second Circuit’s decision would also apply to their cases. The Supreme Court denied their motion in JPMorgan Chase & Co. v. Fed. Hous. Fin. Agency, No. 13M30 (Oct. 7, 2013). The Supreme Court’s ruling effectively leaves intact the Second Circuit’s decision in favor of the FHFA, forcing the banks to choose between costly settlement and expensive litigation. Some banks, including GE, Citi, and JPMorgan, have already responded to these adverse opinions by settling with the FHFA. The other banks will likely face mounting pressure to avoid litigation now that the courts have struck down their strongest defense.

—Matthew Rodgers, Boston, MA
MA High Court Considers the Role of Pre-Foreclosure Notices

The Massachusetts Supreme Judicial Court (SJC) heard oral argument in U.S. Bank National Association v. Schumacher on November 7, 2013, the latest in the line of cases addressing foreclosures and the statutory power of sale in Massachusetts. In Schumacher, the SJC is considering whether a lack of strict compliance with the notice provisions of M. G. L. c. 244, § 35A renders an extrajudicial foreclosure sale void, voidable, or otherwise affects its validity.

In Schumacher, the required Section 35A notice listed the name and address of the mortgage servicer, rather than the mortgagee, and identified U.S. Bank as the current mortgagee despite the fact that the mortgage at issue had not yet been assigned to U.S. Bank. The bank went on to foreclose, after being formally assigned the mortgage, and Schumacher raised the issue of the Section 35A notice during the subsequent eviction proceeding in the Massachusetts Housing Court. Judgment subsequently issued in favor of U.S. Bank, granting the bank possession of the foreclosed premises and costs. Schumacher appealed and the case was transferred to the SJC.

To date, the major foreclosure decisions from Massachusetts have not addressed the notice requirements and their effect on the foreclosure process. Thus, Schumacher presents yet another issue of first impression in the Massachusetts foreclosure arena. Is the notice required by Section 35A part of the statutory power of sale, such that a failure of strict compliance voids the foreclosure sale ab initio, like the issues addressed in Ibanez and Eaton previously covered in articles and developments posted here? Or does a failure to strictly comply render the foreclosure sale voidable, subject to a review of the specific facts on a case-by-case basis?

One of the issues raised by the SJC at oral argument was whether there was actual prejudice to a borrower who receives a notice that (1) provides an accurate recitation of the debt due, (2) provides contact information that the borrower can use to reach out regarding options, and (3) notifies the borrower about options available but which identifies the mortgagee as an entity that does not yet hold the mortgage.

In Schumacher, the question is further muddied by the fact that U.S. Bank, the identified mortgagee, was the holder of the note in question at the time the Section 35A notice was sent. Thus, did Schumacher suffer any actual prejudice? Conversely, Schumacher’s argument does not rely on any finding of prejudice. Rather, Schumacher points back to Ibanez and the SJC’s holding that the requirements of the statutory power of sale necessitate strict compliance. However, Schumacher’s position necessarily requires the SJC to determine that the Section 35A notice is part of the statutory power of sale and it is unclear how the court will come down on that question.

A determination that the Section 35A notice requires strict compliance will add yet another layer of vigilance to the foreclosure process. The SJC did not do much to telegraph its position on this
issue and so, again, the real estate bar will await guidance from the state’s highest court on foreclosures in Massachusetts.

—Kendra L. Berardi, Robinson & Cole LLP, Boston, MA