A Proper Lesson on an Improper Exercise of a Power of Appointment

By David C. Valente

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In a recent case handed down by the Nebraska Supreme Court (the “Court”), *In re Robert L. McDowell Revocable Trust*, the Court considered the validity of the exercise of a limited testamentary power of appointment in favor of the powerholder’s own revocable trust, ultimately finding the exercise to be ineffective and void. In addition to providing a thoughtful lesson on powers of appointment, the Court’s holding serves as a cautionary tale to trustees who are required to act on purported exercises and underscores the importance of careful draftsmanship.

Robert and Betty Dowell, husband and wife, executed revocable trusts in 2001. Robert predeceased Betty, to whom he granted a limited testamentary power of appointment over assets remaining in a subtrust established upon his death (the “Power”). Permissible appointees included one or more of Robert’s descendants, the spouses of any descendants and tax-exempt organizations. To the extent any remaining assets were not effectively appointed by Betty through a last will, the remainder would be divided equally among Robert and Betty’s two surviving daughters, Jane O. Hornung (“Jane”) and Sandra K. Stockall (“Sandra”).

Through a last will executed subsequent to Robert’s death, Betty exercised the Power, or so she thought. Betty attempted to exercise the Power in favor of her own revocable trust, the terms of which excluded Jane as a beneficiary. Upon Betty’s death, the trustee of Robert’s subtrust, acting in compliance with the Power, distributed all of its assets to Betty’s trust. Jane filed suit in county court requesting instructions and declaration of beneficiaries’ rights pursuant to Robert’s trust. Jane alleged the exercise of the Power was invalid and as a result, the remaining assets in Robert’s subtrust should have been divided equally between her and Sandra. Sandra counterclaimed, requesting the court to enter an order validating Betty’s exercise and approving the distribution to Betty’s trust. The court found that Betty’s exercise was invalid because it exceeded the scope of the limited Power insofar as it commingled Robert’s subtrust’s assets with Betty’s trust’s assets, potentially benefiting Betty, her estate and its creditors – none of which were permissible appointees of the Power. Sandra appealed, and the Court granted her petition to bypass the Nebraska Court of Appeals.

In its opinion, the Court espoused the cardinal principal of the construction of powers of appointment, namely that the donor’s intention is controlling. The Court found that in the clear and unambiguous terms of the Power Robert granted to Betty, he limited the class of appointees. Betty purported to exercise such Power in favor of the trustee of her own revocable trust, to be held and administered as part of its property. The Court acknowledged that the remainder beneficiaries of Betty’s trust were Sandra and several of Robert’s grandchildren, *all of whom were permissible appointees of the Power*. To this end, Sandra argued that because the subject property would ultimately pass to individuals who were permissible appointees, the Power should be given effect. Meanwhile, Jane argued that an appointment to Betty’s trust – an impermissible appointee – rendered the appointment ineffective, regardless of whether the underlying beneficiaries of Betty’s trust were permissible appointees of the Power. As the Court had not previously decided the
issue, it looked to the decisions of other jurisdictions for guidance. Ultimately, the Court found the coup de grâce was the absence of express language segregating the powerholder’s own trust’s assets — which were subject to the powerholder’s creditors and the creditors of her estate — from the appointive property. Had the terms of Betty’s trust expressly provided that the appointive assets were not to be comingled with other assets held by (or pouring into) Betty’s own trust, Betty’s exercise would have been valid, rather than being ineffective on account of benefiting non-objects of the Power.

The Court included a fascinating discussion of the doctrines of selective allocation and substantial compliance, but concluded that neither saves the invalidity of Betty’s exercise. Selective allocation is recognized by Restatement (Third) of Property, which provides, “If the donee of a power of appointment exercises the power in a document that also disposes of owned property, the owned and appointive property are deemed to be allocated in the manner that best carries out the donee’s intent.” 2 The Court notes that Massachusetts, Pennsylvania and New York (but not Nebraska) have recognized the doctrine, but that the Court could not find any reported case applying the doctrine in the past forty years.

The Court was not persuaded by Sandra’s argument that the exercise should be deemed valid because it would have ultimately benefited individuals who were permissible appointees, i.e., Robert’s descendants, nor was it persuaded by the observation that Betty’s own estate has sufficient assets to cover her debts and expenses, and thus the appointive assets would not have in fact benefitted Betty’s creditors, Betty’s estate or its creditors.

Meanwhile, the trustee of Robert’s subtrust had distributed the subtrust’s property to Betty’s trust pursuant to Betty’s exercise of the Power. The lower court had found that the trustee of Robert’s trust had acted reasonably and in good faith, but the Court concluded this decision to be plain error on account on the ineffectiveness of the exercise. As a result, the trustee of Robert’s trust was found to have committed a breach of trust.

The Court’s own research suggested that legislatures in numerous states recognize selective allocation through their adoption of some of all of the Uniform Powers of Appointment Act. However, the Court’s decision should serve as a reminder to all estate planning attorneys to consider including language, in a powerholder’s trust intended to receive appointive assets, that segregates such trust’s assets from the appointive assets. Alternatively, the powerholder might consider appointing assets in favor of an irrevocable trust for the benefit of permissible appointees, to avoid altogether an assertion that the exercise might potentially benefit the powerholder, her creditors, her estate or its creditors. The Court’s decision should also serve as a reminder to trustees to closely examine the terms of any purported exercise to ensure its method of prescribed execution was followed strictly.

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1 In re Robert L. McDowell Revocable Trust, 296 Neb. 565 (2017).
2 Restatement (Third) of Property: Wills and other Donative Transfers § 19.19 (2011)
Who Gets What When a Real Property Lease Terminates? The Necessity of Good Drafting to Avoid Personal Property Disputes

By: Justin Lewis¹ and Allen Trask²

Who gets what when a lease of real property is over? This is a question that can be problematic for both landlords and tenants. If the tenant installed additional improvements or made alterations to the premises, will they become the landlord's property when the lease terminates?

What about "trade fixtures" that the tenant installed that were needed specifically for the tenant's business; and what exactly is a "trade fixture"? Or what about inventory, equipment, or other personal property abandoned by the tenant after the tenant leaves the premises? These issues come up often in commercial leases and are best addressed when drafting the lease, not when the situation arises.

Improvements

Tenants often make additional improvements or alterations to the leased premises during the term of the lease. If the lease is silent on what happens to the improvements or alterations once the lease terminates, the landlord and tenant could end up in a costly legal battle to determine who owns the improvements or alterations.

Any additional improvements or alterations, other than so-called "trade fixtures" made by the tenant will likely become the landlord's property once the lease terminates since the landlord owns fee title to the real property on which the premises are located and permanent improvements or alterations cease to be personal property (i.e., bricks, uninstalled shelving refrigeration equipment) and become a part of the landlord's real property unless they are determined to remain the tenant's property because they are mere "trade fixtures", but there is no need to leave this determination to a judge or jury.

In order to avoid any confusion when the lease terminates, the landlord and tenant should include a clear provision in the lease stating what will happen with the improvements made by the tenant when the lease terminates.

Typically, leases provide that the improvements and alterations become part of the premises and belong to the landlord, which memorializes the default rule. But it is also possible that in some circumstances, the landlord does not want the improvements after the lease terminates. In that case, the landlord may want the tenant to restore the premises to the condition they were in prior to the commencement of the lease.

The landlord should include a provision in the lease that allows the landlord to either keep the improvements as part of the property or require the tenant to remove the improvements and restore the premises, at tenant's expense, at termination of the lease. The landlord also should consider an approval right over any improvements made by the tenant. Regardless of the plan, the fate of the improvements and alterations should be addressed when the lease is drafted.
Fixtures; Are They the Landlord's Real Property or the Tenant's Personal Property "Trade Fixtures"?

Trade fixtures are items that are installed in the premises by the tenant solely for the purpose of conducting the tenant's business. As stated above, fixtures are often considered part of real estate, but this can be an unclear area of the law, and property installed by a tenant may be considered a trade fixture that can be removed by tenant at the end of the lease.

In North Carolina, as in many states, it's the "intent of the parties" that determines whether an improvement is a real property fixture that belongs to the landlord or a trade fixture that belongs to the tenant. If the parties know what the improvements will be, such as gas pumps, underground gas storage tanks, and large overhead awnings for a gas station; refrigeration equipment and shelving for a grocery store, or stoves and ovens in a restaurant, the lease should clearly state whether the parties intend for them to be real property fixtures that will belong to the landlord or trade fixtures that will belong to the tenant.

But many alterations and improvements are not, or cannot be, spelled out, especially in a long term lease when such items don't even exist at the time the lease is executed. When there is a dispute in those cases, the "intent" of the parties will be determined by a judge or jury "inferring" from the nature of the property and its use the unexpressed "intent" of the parties unless the parties have the forethought to amend or supplement the lease with an explicit expression of their intent as to the particular item.

The status of the property as a trade fixture may depend on simple things such as the way the item is installed, the life expectancy of the item, and how easily the item may be removed. It's easy for a landlord and tenant to disagree when deciding whether an item installed by the tenant is a permanent part of the real property or a trade fixture. Therefore, it is best to include a provision in the lease that clearly states whether the fixtures become a part of the real property and thus the property of landlord or if the tenant has the option (or can be forced at landlord's option) to remove the fixtures at the end of the lease.

Fixtures are also often a point of contention when issues of solvency are in play, such as when a personal guarantee of a lease expires after a certain period of the tenant's demonstrable solvency. Since fixtures typically are property of the landlord while they are installed, the tenant could be in a situation where the fixture is an asset of the landlord on the books, but the tenant carries the debt as a liability. This can impact a traditional solvency equation.

There also are practical differences between certain fixtures and the way they impact the property. A bolted down but otherwise portable commercial stove is much less impactful than a commercial stove hood and vent, which likely is tied directly into the roof system. The former is easily removed, the latter is not. Regardless of the specific situation or item, it's critical to thoughtfully consider the fixtures that are or could be
installed by the tenant and to determine, and, on the front end explicitly state in the lease, how those items will be handled.

**Abandoned Property**

Another complicated scenario occurs the tenant leaves the premises (after termination of the lease or earlier) and abandons some of its personal property or inventory. Sometimes the tenant simply leaves behind trash which the landlord may dispose of, but there are times when tenants leave behind valuable inventory or equipment. Those situations can become difficult for the landlord if the lease is silent on the issue. The landlord often simply wants the tenant to remove its personal property, so that the landlord is not responsible for it and the premises can be prepared for the next tenant. However, if the tenant refuses to pick up its property, or the landlord cannot locate the tenant after the lease terminates, the landlord will have to do something with property that does not belong to the landlord.

Absent clear remedies in the lease, the landlord may have to face arguments from the tenant about a variety of things, from mishandling of the items, to unjustified conversion and sale, and the like. Even if the landlord is in a strong position regarding such arguments, it often is the actual fight to win that is more costly, both from the standpoint of money and time. It's simply better to avoid the dispute altogether with thoughtful and appropriate lease provisions that clearly state the landlord's options regarding tenant's abandoned personal property.

**Conclusion**

All the potential problems described above will only be problems if the lease does not address these issues explicitly. Both the landlord and tenant can avoid headaches in the future by taking the time to carefully draft the lease and include provisions to address improvements, alterations, fixtures, and abandoned personal property.

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2 Allen focuses his practice on assisting those who own, manage, and invest in real estate and common interest communities. He frequently represents commercial landlords in the management of commercial investment properties, including lease negotiation, interpretation, amendment, and enforcement.
Virginia Passes Legislation Narrowing Definition of “Resident Estate or Trust” for State Income Tax Purposes

On Friday, February 15, 2019, Governor Northam approved House Bill 2526 ("HB2526"), which will change the definition of “resident estate or trust” to no longer include an estate or trust being administered in the Commonwealth. The change could have particularly dramatic tax consequences for trusts created by out-of-state individuals with Virginia trustees.

Virginia imposes a state income tax on essentially all of the federal taxable income of resident estates and resident trusts. The definition of “resident estate or trust” is found in Virginia Code § 58.1-302, which provides for the following four categories of resident estates and trusts:

1. The estate of a decedent who at his death was domiciled in the Commonwealth;
2. A trust created by will of a decedent who at his death was domiciled in the Commonwealth;
3. A trust created by or consisting of property of a person domiciled in the Commonwealth; or
4. A trust or estate which is being administered in the Commonwealth.

Currently, trusts administered by a Virginia trustee are considered “resident trusts” under the fourth category of the definition of “resident estate or trust.”

Pursuant to the adoption of HB2526, the fourth category of “resident estate or trust” will be deleted from Virginia Code § 58.1-302, effective July 1, 2019, leaving only the first three categories listed above.

As a result of the change made by HB2526, it is expected that a non-testamentary trust (that is, an inter vivos trust) created by a person domiciled outside of Virginia will only be taxed by the Commonwealth on its Virginia source income. Thus, if such trusts do not receive Virginia source income, it is expected that they will no longer be subject to state income taxation in Virginia.

If you have any questions about federal or state income taxation of estates or trusts, including the effects of Virginia’s new definition of “resident estate or trust,” please contact any member of our team.
Considerations for Environmental Due Diligence

By: JOHN B. KING, Partner
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Due diligence conducted when acquiring assets in a commercial transaction, whether the assets include property with existing operating facilities or undeveloped property on which a facility is to be constructed, is absolutely essential to ensuring the property does not contain unknown environmental liabilities and is suitable for the buyer's intended use. Of course, the level of due diligence and the time and money spent on it will vary depending on the size and nature of the acquisition. But it should never be less than enough to obtain sufficient information about potential liabilities and future uses so a buyer may make an informed decision.

Phase I Environmental Site Assessments are routinely done as part of the purchase of developed and undeveloped property. They can provide valuable information to a buyer about the possibility of contamination and environmental liabilities. Environmental sampling can also provide information about the extent of contamination and the steps necessary to address the existing contamination.

This information can be used in at least two ways. First, a properly done Phase I serves to establish one element of an important legal defense that allows a buyer to purchase property with known contamination without liability for that contamination, if all other elements of the defense are met. Second, it allows a buyer to negotiate a reduced purchase price, a "set-aside" or perhaps some other contractual arrangement so the contamination may be appropriately addressed. In short, this information can play an important role in defining the structure of the acquisition and the rights and duties of the buyer and seller.

Many do not realize, though, that proper due diligence requires much more. For example, the operations of an existing facility must be completely understood so a determination may be made as to whether the facility is in compliance with applicable regulations. Obviously, obtaining this knowledge prior to the actual purchase is important, as the lack of necessary permits may require operations cease until they are obtained. Further, the buyer and seller can discuss and negotiate the method or process to achieve compliance and the responsibilities and costs associated with that effort.

Additionally, there are two often overlooked components to environmental due diligence. For an existing facility, the history of opposition from neighboring communities, whether in the form of complaints, opposition to permits or citizen suits, should be investigated. It is important to understand possible future opposition to permit renewals, facility modifications or facility expansions. Further, local governments are increasingly enacting land use ordinances that require an approval for certain types of industrial or commercial use and impose conditions on that use. These ordinances may apply to expansions for developed facilities or the initial development of undeveloped
property. Either way, they must be understood so the relative difficulty of obtaining the necessary approvals can be evaluated.

These are just a few of the many considerations that should be integral parts of proper environmental due diligence efforts. With proper due diligence, necessary information can be obtained and evaluated, allowing informed decisions to be made. Without it, unwelcome surprises such as a lack of permits, costly environmental remediation or local regulatory impediments to expansion may impair the buyer’s ability to realize its investment expectations.

John B. King is a partner with Breazeale, Sachse & Wilson LLP in Baton Rouge, Louisiana. His practice relates mainly to environmental regulatory permitting and compliance. Prior to joining the firm in 2003, he served as chief attorney for enforcement for the Louisiana Department of Environmental Quality.

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CASE SUMMARY†

_Estate of Streightoff v. Comm’r_, T.C. Memo. 2018-178

Benjamin A. Cohen-Kurzrock* 

On October 24, 2018, the Tax Court released a memorandum opinion authored by Judge Kerrigan, captioned _Estate of Frank D. Streightoff, Deceased, Elizabeth Doan Streightoff, Executor v. Commissioner of Internal Revenue_, T.C. Memo. 2018-178. The case arose from an estate tax deficiency of $491,750 and raised an issue regarding the type and value of an interest in a closely held entity that the decedent transferred to his revocable trust. This case summary summarizes that opinion.

I. Facts

A. Streightoff Investments, LP and Streightoff Management, LLC

On October 1, 2008, the decedent, through his daughter Elizabeth Doan Streightoff (“Elizabeth”), who held the decedent’s power of attorney, formed Streightoff Investments, LP, a Texas limited partnership (“Streightoff Investments”). Streightoff Management, LLC (“Streightoff Management”) was Streightoff Investments’ sole general partner and was managed by Elizabeth, in her individual capacity. The initial limited partners were the decedent, his daughters, and his former daughter-in-law, each of whom received her interest upon formation by a gift from the decedent that was reported on his 2009 gift tax return. The decedent funded Streightoff Investments with cash and marketable debt and equity investments (e.g., stocks, bonds, and other investments).

Streightoff Investments’ partners entered into a limited partnership agreement, which included the following relevant provisions:

- the general partner controlled the partnership, subject only to limitations set forth expressly in the partnership agreement;

- the partnership would terminate on December 31, 2075, unless sooner terminated by the happening of certain events (e.g., the removal of the general partner, which could occur by written agreement of the limited partners holding at least 75% of the partnership interests held by all partners);

- interests in the partnership were subject to transfer restrictions under which, except in the case of a transfer to a “permitted transferee” (i.e., any member of the transferor’s family; the transferor’s executor, trustee, or personal representative obtaining such interest at death or by operation of law; or to any purchaser, subject to the right of first refusal provided for in the partnership agreement), which was not restricted; a limited partner could not sell or assign the partner’s interest without obtaining written approval of the general partner; and in the case of an...
assignment absent that agreement, the transferor would continue to
have certain obligations to the partnership until the transferee, who
would be treated as holding an assignee interest entitled only to
allocations and distributions, was admitted as a partner; and

• Priority family members (*i.e.*, the transferor’s spouse, natural or
  adopted lineal ancestors or descendants, and trusts for their
  exclusive benefit), the partnership, and the general partner had a
  right of first refusal under which each had the opportunity to acquire
  the interest of a partner who received an outside purchase offer for
  such interest at the same or better terms than those offered by the
  outside purchaser.

B. The Frank D. Streightoff Revocable Living Trust

On October 1, 2008, the decedent established the Frank D. Streightoff
Revocable Living Trust (the “Living Trust”). On the same day, he, through Elizabeth as his
attorney-in-fact, assigned to the Living Trust (a permitted transferee under the Streightoff
Investments’ partnership agreement) his 88.99% limited partnership interest in Streightoff
Investments.

C. The Estate Tax Return and Notice of Deficiency

The decedent, a Texas resident, died on May 6, 2011, and Elizabeth was the
executor of the decedent’s estate (the “Estate”). On August 8, 2012, Elizabeth filed the estate
tax return and reported a gross estate less exclusions of $5,051,299 as of November 6, 2011,
using the alternative valuation date.

On November 6, 2011, Streightoff Investments had a net asset value
(“NAV”) of $8,212,103. The decedent’s interest in Streightoff Investments was reported
as an 88.99% assignee interest with a value of $4,588,000, after applying a 37.2%
discount. In its notice of deficiency, the Commissioner determined that the decedent’s
interest in Streightoff Investments had a value of $5,993,000.

II. The Tax Court’s decision

After readily dispensing with the Estate’s challenge to the notice of
deficiency, which the Estate previously lost on summary judgment, the Tax Court focused
its analysis on two principal issues: (1) the nature of the property interest transferred by
the decedent to the revocable trust and (2) the value of that interest as of the alternate
valuation date.

A. Nature of the Transferred Interest

The Estate and the Commissioner disagreed over whether the 88.99% interest
in Streightoff Investments held by the Living Trust was an assignee interest or a limited
partnership interest. The Tax Court acknowledged that, generally, “[s]tate law determines the
property interest that has been transferred for estate tax purposes.” *Id.* at 15 (citing *McCord v. Comm’r*, 120 T.C. 358, 370 (2003), *rev’d and remanded on other grounds*, 461 F.3d 614 (5th Cir. 2006)). But, the substance of a transaction, rather than its form, can adjust the ultimate tax effect of the determination under state law.

The Tax Court, therefore, considered the form and the substance of the decedent’s transfer to the Living Trust to determine the nature of its interest in Streightoff Investments, ultimately concluding that the transferred interest was a limited partnership interest. Two principal reasons supported the Tax Court’s conclusion: first, a limited partnership interest was transferred in form because the assignment was sufficient for transferring a limited partnership interest in Streightoff Investments and admitting the Living Trust as a partner; and second, in this case, there was no material1 difference between a limited partnership interest and an assignee interest. Thus, “as a matter of both substance and form, the interest to be valued for estate tax purposes [was] an 88.99% limited partnership interest in Streightoff Investments.” *Id.* at 21.

**B. Value of the Transferred Interest as of the Alternate Valuation Date**

The Tax Court reiterated well-known standards for gift and estate tax valuations: (1) the fair market value of an interest is a question of fact that is aided (but not controlled) by expert opinions; (2) that value is the price at which the property would change hands between a willing buyer and a willing seller under no compulsion to buy or sell and both having reasonable knowledge of relevant facts; and (3) the hypothetical willing buyer and seller are presumed to be dedicated to achieving maximum economic advantage.

The parties relied on expert opinions to determine the value of the transferred interest in Streightoff Investments. The experts agreed that, because Streightoff Investments was an asset holding company, the most appropriate method for valuing the transferred interest was based on its pro rata NAV less discounts. While the NAV was stipulated, the experts disagreed over the appropriate discounts that applied when determining the value market value of the transferred interest.

With respect to the discount for lack of control, the Commissioner’s expert determined that no such discount was merited because, as the holder of an 88.99% limited partnership interest, the partnership agreement provided the holder with significant influence and control over the Streightoff Investments’ management. The Estate’s expert, on the other hand, applied a 13.4% discount for lack of control based on the transferred interest being an assignee interest. Because the Tax Court determined that the transferred interest was a limited partnership interest, it applied no discount for lack of control.

With respect to the discount for lack of marketability, the Commissioner’s expert determined that an 18% discount was appropriate. That determination was based on data from newer restricted stock studies and Streightoff Investments’ ability to make distributions, strong financial conditions and prospects, highly liquid assets, asset diversification, and right of first refusal. The Estate’s expert, on the other hand, determined that a 27.5% discount for lack of marketability was appropriate based principally on older restricted stock studies (because of the
longer expected holding period) and the transferred interest being an assignee interest. Once again, because “[the Tax Court] concluded that the interest [the] decedent transferred was a limited partnership interest, the estate’s experts’ valuation [was] too high,” finding, instead, that the analysis by the Commissioner’s expert was reasonable. *Id.* at 27. As a result, the Commissioner prevailed on every issue.

III. Conclusion

_Estate of Streightoff_ is a recent memorandum decision from the Tax Court discussing interesting issues that might arise when a taxpayer’s estate plan involves the use of a closely held entity. Experience suggests that the Commissioner sometimes focuses on closely held entities when examining a taxpayer’s gift or estate tax return. That focus might arise from valuation issues inherent in closely held entities (e.g., the opinions of business valuation experts regarding the fair market value of an interest in a closely held entity often differ). _Estate of Streightoff_ demonstrates that point.

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† This article is designed to provide information about the subject matter and has been prepared with the understanding that neither the author of this case summary nor Baker Botts L.L.P. is providing accounting, tax, or legal advice or is performing any legal, accounting, or other professional service. If accounting, tax, or legal advice or other expert assistance is required, seek out the services of a competent professional person.

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1 The Tax Court determined that restrictions on an assignee interest’s information rights were immaterial in this case because Elizabeth was both general partner and trustee of the Living Trust. Analogizing to the position taken in _Kerr v. Comm’r_, 113 T.C. 449, 467 (1999), the Tax Court also determined that restrictions on an assignee interest’s voting right “would have been of no practical significance.” *Id.* at 20.
The Language of Loans
By Erik North

“E-mail Delaware counsel and tell them we need the two Delaware opinions, a non-con and a UCC perfection opinion for the Westwood deal. Make sure you send them the searches, pairings, good standings and a recycled SPE certificate. After that, call the consultant and tell him we have a Fannie defeasance and our client wants to take the Successor Borrower residual up-front.”

Let’s say you are a first year attorney yet to receive your bar results and the head of your firm’s Real Estate practice just said this to you without taking a breath. She gives you an appreciative nod and smile as she joins a two hour conference call to negotiate the waterfall in a JV agreement where we represent the operator and The Money is trying to reduce our client’s promote. To quote Bill Murray in the 1981 movie Stripes, “and then, depression set in.”

Perhaps the most challenging aspect of starting as a junior associate in a real estate finance practice is just figuring out what coworkers are saying. Law schools do not teach real estate finance speak, and it is far from intuitive. Much like the “alphabet soup” of federal government agencies, the practice of real estate finance law comes with its own nomenclature of slang and abbreviations. Many lawyers with years of real estate experience still come across unrecognizable terms. This highly specialized, ever-changing vocabulary can leave the unindoctrinated feeling as if they just stepped off a plane in a foreign land and not understanding a word of the local tongue.

Many anachronistic words still remain in today’s form loan documents, despite a total lack of contemporary applicability. For example, two old-school terms still seen in deeds of trust from time to time are “enfeoff,” and “dower and curtsey.” “Enfeoff” is a term dating back to feudal England meaning to give someone—perhaps a fortunate serf on the estate of the local nobleman—land in exchange for pledged service or otherwise. “Dower and curtsey” also date back to old England, pertaining to the right of a surviving spouse to an interest in real property upon the death of his or her wife or husband. “Dower” generally refers to a widow’s right to property, while “curtsey” refers to a widower’s right to property. A few states and commonwealths, e.g., Arkansas and Kentucky, still have dower laws on the books. California does not (nor does it have serfs or noblemen). Nonetheless, these terms continue to appear in loan documents and thus are worth knowing. There are a variety of real property financing options commonly identified by terms that are not as high concept as “acquisition loan” and “construction loan.” One example is a “wraparound mortgage” or “all-inclusive deed of trust,” which is basically the equivalent of subleasing a mortgage loan. Generally appearing in connection with a sale of real property, the buyer/borrower under a wraparound loan agrees to make payments to the seller/original borrower of an underlying conventional loan secured by real property and to abide by the terms of the original borrower’s loan documents. Unlike a “loan assumption,” where upon purchasing the mortgaged property the new borrower steps into the shoes of the original borrower and assumes the original borrower’s obligations pursuant to an agreement with the lender, in a wraparound loan,
the agreement is between only the new borrower and original borrower, and may exist without the secured lender’s knowledge. If asked to document a wraparound loan, the first question should be, “Is this being done to circumvent the due on sale clause in the underlying deed of trust?” If the answer is yes, it is best to pass on the opportunity.

Another creative form of real property financing is a “shared appreciation loan,” often evidenced by a “contingent interest promissory note.” Under the terms of a shared appreciation loan the lender agrees to accept as part of its payment for making the loan a portion of the appreciated value of the mortgaged property realized upon its sale or other transfer. Typically, a shared appreciation loan is evidenced by a contingent interest note in a nominal amount (e.g., $5,000) secured by a contingent interest deed of trust. In most cases, a traditional promissory note in the full principal amount of the loan and an accompanying deed of trust are also included among the loan documents, although in many transactions the promissory notes may be combined.

“Hard money” loans may sound like something from the film *Goodfellas*, but in fact such loans fill an important niche in the world of real estate finance.³ Often, a hard money loan is a “bridge loan,” the function of which is just like it sounds: It is a bridge, and the span being bridged is time. Bridge loans and hard money loans can be a useful form of short-term financing, providing a source of acquisition funds while entitlements are being processed and construction or permanent financing is being arranged. This is also particularly helpful if the closing timeframe under a purchase agreement is shorter than the anticipated due diligence and documentation period for a bank loan that will ultimately finance the property. Hard money loans also provide a source of financing for borrowers who may not be considered sufficiently creditworthy to obtain a traditional loan. Hard money lenders tend to focus on the value of the collateral relative to the loan amount. These lenders are able to move quickly and require less in the way of due diligence and underwriting than traditional lenders. However, convenience has its cost. Hard money loans usually come with interest rates greater than those of traditional alternatives. Additionally, when obtaining financing of this nature, a borrower should always be wary of a “loan to own” play, in which a lender makes or buys a loan with the intention of foreclosing on a distressed property as a means of acquiring it below market value.

Two types of loans commonly referred to interchangeably but actually having distinct characteristics are “syndicated loans” and “loan participations.” Documents for a syndicated loan create a one-to-many relationship among the borrower and multiple lenders. An “administrative agent” or similar lead lender will oversee and manage the loan under the terms of a single loan agreement, but each syndicated lender will likely hold its own promissory note evidencing its portion of the loan. By contrast, a loan participation is a one-to-one-to-many relationship evidenced by loan documents between the borrower and a single lender on the “front end” and on the “back end” by a participation or similar agreement between the originating lender and each of the participating lenders purchasing an interest in the loan. The terms of a syndicated loan governing the relationship among the lenders are included in the loan agreement to which the borrower is a party. The terms of a participated loan governing the relationship among the
participating lenders are set forth in a separate agreement to which the borrower is not a party and will likely never see.

**Mezzanine Loans**

A form of real property financing not actually secured by real property is a "mezzanine loan." To secure a mezzanine loan, the mezzanine lender takes a pledge and grant of security interest in the limited liability company or partnership interests in an entity that owns real property (often called "pledged interests"). This pledge is made by the owner or owners of an entity owning real property, which is usually a mortgage borrower under a separate loan. If a default should occur under the "mezz" loan, the mezz lender forecloses on the pledged interests pursuant to Article 9 (Secured Transactions) of the Uniform Commercial Code (UCC) of the state set forth in the governing law provisions of the pledge agreement. Following the UCC foreclosure, assuming the mezzanine lender is the successful bidder, the mezzanine lender steps into the shoes of the former owner or owners of the mortgage borrower, becomes the owner of the mortgage borrower, and as such takes control of the subject real property. However, the real property encumbered by the mortgage loan remains subject to the mortgage loan, which continues in effect after the mezzanine foreclosure. With the mortgage borrower now under the mezzanine lender's control, the mortgage borrower must continue to pay debt service on the mortgage loan in order to avoid a real property foreclosure like any other mortgage borrower. The interest rate on a mezzanine loan is higher than that of its mortgage loan counterpart because a mezzanine loan is structurally subordinate to a real property mortgage loan; however, as secured financing, it is still superior to equity investments.

For a mental image, one can imagine a Broadway theater in which the orchestra seating is the mortgage loan. The mezzanine loan is the mezzanine level above the orchestra seating but below the balcony where equity investors are seated. This layering of funding sources is called the "capital stack." Some capital stacks include a "junior mezzanine loan" and "senior mezzanine loan." Continuing with the analogy, the junior mezzanine loan is the lower balcony, situated above the mezzanine tier and below the upper balcony where the equity investors sit. In order to manage the rights of each of the lenders in the capital stack relative to each other, the mortgage lender and each of the mezzanine lenders enter into an "inter-creditor agreement." Mortgage and mezzanine borrowers are not parties to the intercreditor agreement and are usually not provided with a copy of the document.

Although a security interest in pledged interests may be perfected through the filing of a Form UCC1 with the office of the secretary of state for the state in which the property-owning entity is organized (most frequently Delaware), it is now common practice for mezzanine lenders also to require perfection through possession. To achieve this form of perfection of the mezzanine lender's security interest in pledged interests, the pledged interests must be "certificated" and evidenced by a physical certificate similar to a traditional stock certificate for a corporation. In order to accomplish this, the operating agreement or partnership agreement of the property owner entity whose interests are being pledged must state that it has elected to "opt in" to Article 8 of the UCC, which
governs investment securities. A security interest in pledged interests certificated under Article 8 is perfected by the mezzanine lender taking physical possession of the original certificates evidencing the pledged interests.

Commercial Mortgage-Backed Securities

A practice area practically requiring its own dictionary is that of “Commercial Mortgage-Backed Securities” (CMBS), which covers “Real Estate Mortgage Investment Conduit” (REMIC) or “Conduit” lending. Mortgage-back securities are bonds for which the payment of principal and interests is secured by a pool of commercial real estate loans. This method of raising capital allows investors to participate in the real estate loan market without having to invest in the overhead required to become an originating lender. It also infuses liquidity into the mortgage loan market, which allows originating lenders to offer lower interest rates. The approach of using a pool of many loans to secure bond payments creates a diversification of risk and guards against the economic failure of any single property securing the bonds.

The process of creating the pool of loans and issuing the mortgage-backed securities is called “securitization,” and the “special purpose vehicle” (entity) formed to hold the pool of loans and issue the securities is called a REMIC. This is why loans destined for securitization are often referred to as “conduit loans.” Residential mortgage loans are similarly securitized through a variety of quasi-government agencies known as government-sponsored enterprises (GSE), including the Federal National Mortgage Association (FNMA or “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (FHLMC or “Freddie Mac”).

Loans bound for securitization include certain characteristics designed to protect the holders of the mortgage-backed securities secured by such loans. One such characteristic is the requirement that each borrower in the pool with a loan amount above a certain dollar threshold engage one or two “independent managers” or “independent directors” per the terms of such borrower’s operating or partnership agreement. To the lender, the sole purpose of an independent manager is to vote “no” on any proposal to file for bankruptcy or to seek similar protections under insolvency laws if such filing is contemplated by the borrower’s members or partners. The borrower’s operating agreement or partnership agreement must include a requirement that any bankruptcy filing or similar action on the part of the borrower be approved by an affirmative vote of the independent party. Despite the use of the terms “manager” and “director,” independent managers and independent directors have no economic interest in the borrower and have no rights or authority other than to vote on insolvency matters. In practice, the members or partners of the borrower never meet their independent counterparts as most are professionals engaged through service providers for an annual fee.

An independent manager in some cases may also serve as a “springing member” and under certain conditions a “special member” of the borrower entity. A springing or special member of a limited liability company exists, e.g., solely for the purpose of satisfying the requirement that a limited liability company always have at least one
member. If for some reason all members of the borrower limited liability company withdraw, die, or otherwise cannot serve as members, this member “springs” into place and becomes the special member of the limited liability company, serving as a legal place holder until the real-world people controlling the limited liability company document a new member’s admission. Like an independent manager, a springing member or special member has no economic interest in the borrower entity and no rights or authority under the borrower’s operating agreement.

Another common characteristic of CMBS loans is “cash management.” Since the CMBS bond holders’ goal is to minimize their investment risk to the greatest extent possible, one method of limiting default risk is to have the lender control the revenue generated by the properties securing the loan pool. This prevents the borrower from absconding with property funds and also allows the lender to take an active role in ensuring property revenues are being allocated in a manner that maintains the value of the property. Cash management is implemented through the use of a “lockbox.” For typical bank loans not requiring cash management, the borrower receives income from the property in the form of tenant rent payments and can spend it as it wishes, provided it remains current on loan payments and does not otherwise violate the terms of the loan documents. However, if cash management is in place, all revenue from the property securing the loan must be deposited into a designated “lockbox account” with a bank approved by the lender (sometimes called a “cash trap”). If a “soft lockbox” is in place, property revenue is deposited into a lockbox account or “clearing account,” and the borrower may withdraw funds from the account at its discretion until an event of default or other “trigger event” occurs. If a trigger event occurs, e.g., a borrower’s failure to satisfy a periodic financial success test, the borrower’s access to the lockbox account is blocked by the bank holding the account and the lender takes control of the deposited funds. If a “hard lockbox” is in place, upon closing of the loan, tenants of the property are sent a “tenant direction letter” instructing them to make all rent payments directly to the lockbox account and not to the borrower or property manager. Periodically, funds in the lockbox account are “swept” from the lockbox account and transferred to a lender controlled “cash management account.”

Once in the cash management account, property revenue is held until disbursed to the borrower per the terms of a “cash flow waterfall.” Funds from the waterfall are disbursed into “buckets,” each of which corresponds to a category of property costs (e.g., property taxes, insurance, debt service, required reserves, operating expenses, and mezzanine loan debt service, if applicable). Each bucket represents a deposit into an account or a payment to a party entitled to property revenue, such as a mezzanine lender. Any cash left over is either given back to the borrower or held in an “excess cash flow account” as additional collateral for the loan or for future use with the lender’s approval. Sometimes a “springing lockbox” is established, in which case the borrower has the right to receive and use revenue from the property until a trigger event occurs, at which time a lockbox account “springs” into place and cash management is implemented.

In addition to knowing default risk is being managed, CMBS bond holders also want their expected return on investment to continue for the bond’s entire term. This presents a problem for commercial real estate owners needing the flexibility to sell or
refinance properties before the terms of the loans encumbering such properties have matured. The issue is addressed with the financial devices of “minimum interest,” “yield maintenance,” and “defeasance.” In each case, if the borrower elects to prepay the loan prior to an established date, the borrower must compensate the lender (and therefor the bond holders) for its lost return on investment. Under the minimum interest approach, the lender calculates the amount of interest it would have earned had the loan not been prepaid prior to the permitted prepayment date, and that is the amount the borrower must pay to the lender when the principal amount of the loan is prepaid. “Yield maintenance” is similar to minimum interest; however, instead of using a set dollar amount, the principal and interest that would have been paid if the loan had remained in place until the permitted prepayment date is calculated based on a discounted cash flow formula set forth in the loan agreement.

A “defeasance” is an alternative to yield maintenance that allows a securitized loan to remain in place even after the real property collateral securing the loan has been sold or refinanced. To “defease” a loan is to exchange a portfolio of government bonds as substitute collateral for the real property collateral securing a securitized loan. A loan is defeased when the borrower wants to sell or refinance the property securing a mortgage loan but under the loan documents is not allowed to pay off the loan until a prepayment date, or at least cannot do so without paying yield maintenance. Working with a defeasance consultant, the borrower and loan servicer enter into a transaction pursuant to which the liens and security interests encumbering the property securing the loan are released, and in exchange the loan becomes secured by a portfolio of low risk bonds, T-bills and Treasury notes. Essentially, the parties swap out the type of collateral securing the loan. The borrower usually buys the securities portfolio with the proceeds from the sale or refinance of the property. The securities portfolio is structured (using a computer model) such that each month the income from the bonds in the portfolio is equal to the amount necessary to pay the monthly debt service on the loan. Upon maturity of the loan, the value of the securities remaining in the portfolio is sufficient to pay off the final balloon payment of outstanding principal. A defeasance allows a loan to continue to exist until maturity, which in turn allows the “trustee” responsible for the loan pool to continue to make payments to the holders of the bonds for the entire anticipated term of their investment. Any funds remaining after the pay-off of the loan are called the “residual” value of the securities portfolio. The residual is usually shared by the original borrower and the defeasance consultant.

In order for the defeased loan to remain in place, a “successor borrower” takes the place of the original borrower that owns or owned the real property being released from the lien of the mortgage or deed of trust. The successor borrower assumes the original borrower’s obligations to make payments under the loan documents, thereby allowing for the release of the original borrower from such obligations. The successor borrower is usually formed by the defeasance consultant or loan servicer and serves no purpose other than that of obligor under the defeased loan documents and owner of the securities portfolio purchased at the defeasance closing. A third-party “securities intermediary” holds the bonds in the defeasance portfolio and ensures debt service on the loan is paid from portfolio income.
Additional Characteristics of CMBS Loans

Unlike a traditional bank loan, the borrower and lender parties to a securitized loan part ways shortly after closing and do not maintain an ongoing relationship through the term of the loan. Responsibility for the day-to-day management and collecting debt service under a securitized loan is that of the “master servicer.” While master servicers handle routine approvals and other ministerial functions under the loan documents, if any material decisions regarding the loan are to be made, the loan will be transferred to a “special servicer.” Special servicers commonly become involved in loan assumptions, loan modifications, and any restructuring of the loan that is done in an attempt to avoid foreclosure, commonly referred to as a “workout.” However, the regulations governing REMIC loans serve to limit the flexibility of the special servicer in any workout negotiations.

When structuring the content of loan documents, one of the primary goals of a CMBS lender is to include effective protections and disincentives against the borrower filing or becoming involved in a bankruptcy proceeding. This is in part because the “single asset real estate” (SARE) rules in the U.S. Bankruptcy Code favor mortgage lenders and in part because fighting it out in bankruptcy court with other secured and unsecured creditors is costly and time-consuming with uncertain results. In the event that a mortgage lender finds itself in bankruptcy court, despite its best efforts to avoid it, the ruling a lender really wants to avoid is “substantive consolidation,” in which the assets and liabilities of the mortgage borrower are pooled with those of one or more of its parent companies or affiliates to create a single bankruptcy case in which the SARE rules may no longer apply.

One way CMBS lenders try to avoid substantive consolidation is to require that the mortgage borrower satisfy the requirements of a “single purpose bankruptcy remote entity.” Such an entity is more commonly known as a “single purpose entity” or “special purpose entity” (SPE). The theory is that a mortgage borrower entity satisfying certain SPE covenants will not be substantively consolidated with an affiliated entity in a bankruptcy proceeding. Typical “SPE covenants” require that the SPE own only one real estate asset and no assets unrelated to that asset, engage in no business unrelated to its one real estate asset, and generally keep its books, records, funds, and business activities separate and distinct from the activities of its parent entities and other affiliates. In some cases, the breach of an SPE covenant by a borrower triggers recourse under a carveout guaranty. If an SPE entity has a business history and is not newly formed immediately prior to the closing of a loan, it is called a “recycled SPE” and must reform its entity operations, certify to certain facts, and make the SPE representations in order to provide comfort to the lender that substantive consolidation based on the borrower’s history would be unlikely.

To create a significant disincentive for mortgage borrowers to file for bankruptcy, CMBS lenders generally require a person or entity with substantial net worth, liquidity, and a direct or indirect ownership interest in the borrower to execute a “non-recourse carveout guaranty” or “carveout guaranty.” For those familiar with CMBS speak, the title is self-evident. It is a guaranty of the financial consequences arising from the
exceptions (carveouts) to the non-recourse provisions in the loan documents. Per the terms of a "non-recourse" loan, the lender agrees to look only to the loan collateral for compensation in the event of a loan default and agrees not to pursue any causes of action against the borrower for personal liability. However, in order to place some good faith restrictions on the borrower’s behavior, CMBS loan documents include exceptions to the non-recourse provisions that are triggered if the borrower engages in certain prohibited acts. The most egregious of these borrower transgressions are those that could deprive the lender of its collateral, including the sale of the collateral property without repayment of the loan, a voluntary bankruptcy filing by the borrower, and a variety of other insolvency actions.

Given the risk that any of these events could prevent the lender from foreclosing on its collateral, a violation of any one of these triggers results in the loan’s becoming "full recourse" to the borrower, at which time the borrower becomes personally liable for the entire amount of the loan and all other amounts due under the loan documents. However, since the borrower has no assets other than the property securing the loan, the guarantor parties to the non-recourse carveout guaranty also become liable for such amounts. Trigger events resulting in full recourse to the borrower and guarantor are said to be "below the line." Due to the negative nature of the acts that trigger borrower recourse, traditionally, non-recourse carveout guaranties have been referred to as "bad boy" guaranties. In these more enlightened times, many in the lending community are now calling them "bad act" guaranties.

Although the origin of the term "the line" may be lost in history, given that there are below the line non-recourse carveouts, logic would dictate there must also be “above the line” non-recourse carveouts. “Above the line” non-recourse carveouts are acts of the borrower that are clearly in violation of the borrower’s expected behavior under the loan documents but are nonetheless acts that, while they would likely not result in a complete wipe-out or loss of the lender’s collateral, nevertheless have a negative impact on the real property collateral. If any of these above-the-line acts are committed by the borrower, the borrower and guarantor are only liable for any losses the lender may incur as a result of such actions but not the entire amount of the loan. Above the line recourse triggers are also referred to as "losses carveouts."

In some cases a lender will include non-recourse carveouts that are not at all tied to an illegal, immoral, unethical, or ill-behaved act of the borrower, which may nonetheless result in recourse for events outside of borrower’s control. This approach is called “allocation of risk” and does not necessitate the commission of a bad act to trigger recourse. Thus, it should always be made clear in the term sheet as to whether the recourse triggers in the loan documents will be tied to bad acts or are simply a method of allocating the risk of loss between the borrower and lender.

Legal Opinions Practice

Another area of real estate finance law that comes with its own unique subset of words and phrases is the legal opinions practice. Most legal opinions issued in connection with a mortgage or mezzanine loan are fairly straightforward opinions regarding the
enforceability of the loan documents and/or the power and authority of the borrower parties to enter into the loan documents. Subject to some assumptions and qualifications set forth in the opinion letter, the law firm issuing the opinions states that the subject upon which it is opining is in compliance with applicable law and that the loan documents are enforceable in accordance with their terms. However, in some cases the law is sufficiently vague or untested that a solid legal opinion cannot be issued. In these cases, law firms issue “reasoned opinions,” which typically cite innumerable cases and statutes and eventually arrive at a conclusion as to what a court “should” rule if a case is properly presented and competently argued.

The most commonly reasoned opinions in real estate finance law are “substantive non-consolidation” or “non-con” opinions. A non-con opinion is a reasoned opinion concluding that a bankruptcy court would not substantively consolidate the borrower and certain affiliates of the borrower identified in the non-con opinion letter, such as parent entities and guarantors, if the various assumptions set forth in the opinion letter are correct. The matching of the various entities whose assets and liabilities may be consolidated in a bankruptcy proceeding for purposes of a non-con opinion letter is called the “pairings,” which must be provided to the author of the opinion letter before it can be drafted. A non-con opinion letter is intended to provide comfort to the “rating agencies” (e.g., Standard & Poor’s, Moody’s, Fitch, and others) when they are evaluating loans to be included in a CMBS pool.

Additional opinion letters that rating agencies often require as part of a loan evaluation package are the “Delaware opinions.” Because Delaware corporate, limited liability company, partnership, and bankruptcy law is well established and well known, most CMBS lenders require that mortgage and mezzanine borrowers be formed under Delaware law. The two commonly required Delaware opinion letters are the “Delaware law opinion” and the “authority to file opinion.” Under a Delaware law opinion, the law firm issuing the opinion letter opines that under Delaware law the borrower is a separate legal entity and that such entity is not permitted to file for bankruptcy without the affirmative vote of the independent manager(s). A Delaware authority to file opinion is a reasoned opinion under which the law firm issuing the opinion letter opines that Delaware law, and not federal law, would govern the determination of which persons or entities have the authority to file a voluntary bankruptcy petition on behalf of the borrower entity.

“Non-contravention opinions” are statements contained in an opinion letter that are generally grouped with the opinions but in truth are not legal opinions at all. They are factual confirmations made by the law firm issuing the opinion letter. Typical non-contravention opinions state that the execution and delivery of the loan documents will not violate any laws of a specified state, any contracts to which the borrower parties executing the loan documents are a party, or any existing court orders applicable to the borrower parties.
California Law

Whether working on CMBS loans, hard money loans, or typical bank loans, all California real estate finance lawyers should be familiar with the interpretations of a few key statutes that govern the exercise of a lender’s remedies for loans secured by real property. These include the “one-action rule,” the “security first rule” and California’s “anti-deficiency” statutes. The one-action rule is rooted in California Code of Civil Procedures Section 726(a), which states: “There can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage [deed of trust] upon real property.” Basically, a mortgage lender is allowed one opportunity to exercise its remedies against a mortgage borrower and its collateral property, and that one action under the security first rule must be foreclosure. A violation results in the loss of the lender’s deed of trust on the real estate collateral. This law is intended to prevent a lender from hammering away on a borrower with multiple lawsuits over one loan. Generally speaking, an “action” under the one-action rule means a judgment or judicial action, but may include other actions by a lender that can result in limiting a borrower’s rights with respect to assets not securing the loan, such as obtaining a prejudgment attachment of assets. For this reason, California lenders tend to be very careful when exercising mortgage loan remedies so as to avoid inadvertently exhausting their one permitted action.

An action does not include a non-judicial or “power of sale” foreclosure under a deed of trust, commonly known as a “trustee’s sale.” However, under the “anti-deficiency laws,” a trustee’s sale precludes the exercise of certain other lender remedies (such as suing for a deficiency following the foreclosure sale). The “security first rule” comes from the judicial interpretation of Section 726, pursuant to which creditors with debts secured by real property must exhaust their security for the loan before otherwise proceeding against their debtors for a monetary judgment.

In addition to Section 726(a), the California Code of Civil Procedure also provides protection to mortgage borrowers through a series of statutes known as the anti-deficiency laws, which prevent or limit a lender’s ability to seek a “deficiency” judgment against a mortgage borrower. Under the circumstances set forth in these statutes, a lender cannot seek a monetary judgment against a borrower for the difference between the amount due to the lender under the loan documents and the value realized by the lender through the exercise of its foreclosure remedies. In the context of commercial real estate lending, Section 580d pre-vents a lender from seeking a deficiency judgment against a borrower if the lender foreclosed on the real property collateral pursuant to a trustee’s sale. Section 580c protects borrowers against unreasonable costs and fees associated with a judicial foreclosure. Section 580b prevents a lender from seeking a deficiency judgment against a borrower after foreclosure under a real property “purchase-money” loan (commonly known as seller-financing or an initial residential loan obtained in connection with the acquisition of the residence). Finally, Section 580a, often superseded by Section 580d, prevents a lender from seeking a deficiency judgment against a borrower in excess of the difference between the total debt owed and the fair market value of the foreclosed upon property at the time of the sale. This is intended to prevent lenders from selling a property at foreclosure for pennies on the dollar and then...
suing the borrower for a deficiency greater than that which a fair market sale would have produced. Among the anti-deficiency laws, Section 580d is the most relevant to typical loans secured by nonresidential real property.

Despite the variety of terms used in the legal practice of real estate financing, there are also a few definitions in California law that every real estate lawyer should know. Per Code of Civil Procedure Section 1933, “execution of an instrument” means “subscribing and delivering it, with or without affixing a seal”; therefore, writing “execution and delivery” is redundant. Per Section 9 of the California Civil Code, “[a]ll other days than those mentioned in Section 7 are business days for all purposes.” Section 7 reads: “Holidays within the meaning of this code are every Sunday and such other days as are specified or provided for as holidays in the Government Code of the State of California.” Thus, under California’s Civil Code, Saturday is a “business day.” Per Section 7.1(a), every Saturday is an “optional bank holiday,” but not every lender is a bank. This is why “Business Day” should always be defined in loan documents.

Know Your Audience

As in any highly specialized profession, mastering the jargon of real estate finance law takes time and a career-long attentiveness to the new lingo of the day. However, even once mastered, one must always keep in mind that effective communication requires an understanding of the language by all parties to a conversation. Accordingly, no matter how familiar one becomes with the language of loans, it is always important to adhere to the “know your audience” rule and be ready to offer a plain-speaking explanation of any terms and phrases that might be unknown or confusing to a client, junior associate, or any other party to a discussion.

Erik North was a partner and member of the Joint Venture team at the Los Angeles office of Cox, Castle & Nicholson LLP (“CCN”). Erik unexpectedly passed away on May 18, 2019. CCN deeply misses a valued partner, colleague and friend. CCN knows Erik wanted to extend special thanks to Chelsea Medwin and Ira Waldman for their invaluable help with this article.

Please learn more about Erik in a memo from his friends and colleagues at CCN:


1 STRIPES (Columbia Pictures 1981)
2 See, e.g., BLACK'S LAW DICTIONARY (10th ed. 2014)
3 GOODFELLAS (Warner Bros. 1990)
4 Article 9 of the UCC is designated Division 9 under the California Commercial Code.
7 See CIV. PROC. CODE §§580a-d.
The Child-Parent Security Act: Granting New Yorkers the Right to Benefit From Assisted Reproductive Technology

The CPSA would finally allow New Yorkers the opportunity to exercise the same reproductive rights and family building opportunities that are endowed to the citizens of 48 other states.

By Alexis L. Cirel

The proposed Child-Parent Security Act (CPSA or the Bill) is legislation that would modernize New York’s domestic relations scheme by repealing the prohibition and criminalization of compensated gestational surrogacy arrangements. The Bill would also streamline the establishment of legal parentage for donor-conceived children and regulate the disposition of frozen embryos. This article refutes some of the recently voiced opposition to the surrogacy component of the Bill and highlights the many benefits it would introduce.

In staunchly opposing the CPSA based upon little more than fundamentalist mores, many critics of the Bill resort to scare tactics and biased caricatures from outdated literature, anomalous cases, and legal myths. In actuality, legalizing and closely regulating compensated surrogacy arrangements would bring New York in line with the majority of other states that permit it, would reconcile New York’s statutory scheme with increasing judicial recognition of alternative family structures—including those formed with the help of assisted reproductive technologies, would extend reproductive freedom to New Yorkers, and would reduce the economic risks and legal uncertainties that result from New Yorkers participating in unregulated altruistic surrogacy arrangements within the state and/or compensated surrogacy arrangements outside the state.

To fully respond to criticisms of the Bill, it is necessary to define the relevant terms and components of assisted reproductive technology (ART) and describe the surrogacy process itself. Intended parents (IPs) pursue surrogacy primarily because they suffer from infertility; and/or they have a medical condition that makes pregnancy an unreasonable health risk; and/or they are biologically incapable of carrying a pregnancy (i.e., gay male IPs or women who have lost their uterus after undergoing treatment for cancer or other diseases). IPs pursuing surrogacy can either undergo in vitro fertilization (IVF) (the process by which a woman’s eggs are surgically retrieved and then fertilized with a man’s sperm in a laboratory setting) to create an embryo with their own biological material or use donor egg/sperm. In gestational surrogacy, which is the only form of surrogacy that the CPSA would permit, an embryo resulting from IVF and/or donated genetic material is transferred into the uterus of a third-party woman who did not contribute the egg, and she gestates or carries the pregnancy to term. In other words, a person acting as a gestational surrogate has no biological connection to the child (which is distinct from “traditional surrogacy” arrangements, which are not permitted by the Bill, in which the woman who carries the pregnancy also contributes the egg and thus has a biological connection to the resulting child.) IPs and persons acting as
gestational surrogates most commonly find each other through matching programs which carefully screen candidates for both suitability and compatibility.

The legislation banning surrogacy agreements in New York is Article Eight of the state’s Domestic Relations Law, which was enacted in 1992. Article Eight declares all surrogacy arrangements “contrary to the public policy of [New York and] void and unenforceable” and makes it per se illegal to compensate a surrogate beyond certain limited permissible payments (i.e., payments associated with adoption and permitted by the social services law, and payments for reasonable and actual medical fees and hospital expenses for artificial insemination or in vitro fertilization services incurred in connection with the birth of the child). Article Eight also sets forth applicable penalties for anyone who participates in a compensated surrogacy arrangement. New York is one of only two states that criminalizes compensated surrogacy (the other is Michigan). The CPSA proposes to amend Article Eight to exclude gestational surrogacy cases from the prohibition and replace it with a new comprehensive regulation that would permit compensated gestational carrier agreements provided they meet the rigorous standards and best practices embodied in the Bill.

Inapposite Analogies to the Infamous ‘Baby M’ Case: New York’s surrogacy ban followed the controversial New Jersey custody battle, In re Baby M, 537 A.2d 1227 (1988). In that case, an intended father entered into a surrogacy agreement with a woman whom he and his wife found through a newspaper ad. According to the agreement, the surrogate would be inseminated with the intended father’s sperm, bring the pregnancy to term and would then relinquish her parental rights in favor of the intended mother. Thus, the surrogate in that case was a “traditional surrogate” in that she had both a biological and a gestational connection with the resulting baby. After birth, the IPs allowed the surrogate to visit with the child, at which point she and her husband ran off with the infant. The intended parents sued to be recognized as the child’s legal parents. The New Jersey court ruled that the surrogacy agreement was invalid as against public policy, recognized the surrogate as the child’s legal mother, and ordered the Family Court to determine who should have legal custody using a “best interests of the child” analysis. Ultimately the intended father was awarded custody, with the surrogate having visitation rights.

Those who condemn the CPSA by reference to Baby M disingenuously conflate “traditional surrogacy” arrangements, which are specifically excluded from the Bill’s purview, with the gestational surrogacy arrangements contemplated by the Bill. They also omit from their analysis the very salient fact that the state of New Jersey has since legalized the practice of gestational surrogacy. See New Jersey Gestational Carrier Agreement Act, N.J. Stat. 9:17-60, et seq. (signed by the Governor on May 30, 2018).

Unsupported Concerns About a Surrogate’s Autonomy: Some uninformed critics of the Bill argue that compensated surrogacy agreements deprive persons acting as surrogates of their Constitutional right to terminate a pregnancy, and financially disincentivize surrogates
from withdrawing from the agreement before pregnancy is achieved even if it is medically unsound. These allegations are specifically and unambiguously belied by a plain reading of the Bill’s carefully construed requirements.

Under the proposed CPSA: a gestational agreement “may not limit the right” of the surrogate to terminate the pregnancy or reduce the number of fetuses or embryos she is carrying; there “shall be no specific performance remedy available for a breach by the [surrogate] of a gestational agreement term that requires the gestational carrier to be impregnated or to terminate the pregnancy or to reduce the number of fetuses or embryos [she] is carrying”; and the agreement must contain a statement that the surrogate can choose her own doctor. The Bill also militates against concerns about surrogates feeling compelled to go through with the embryo transfer by requiring every agreement to state that it can be terminated before a pregnancy is achieved without penalty.

Claims That Compensated Surrogacy Is ‘Baby Selling’ and Commoditizes Women: Critics also demonize the proposed CPSA for allegedly condoning “breeding for adoption” or “baby selling.” It is argued that compensated surrogacy arrangements are necessarily exploitative of lower-class women who become surrogates because they are “desperate and destitute” and therefore deprived of their reproductive freedom. Aside from the incongruous nature of this position (certainly a wholesale prohibition against a woman’s right to act as a surrogate and to be compensated for it is a worrisome deprivation of liberty), it ignores extensive social science research on the issue which finds that there are no deleterious effects on women who have been surrogates or their families. See, e.g., New York Task Force on Life and the Law, Revisiting Surrogate Parenting: Analysis and Recommendation for the Public Policy on Gestational Surrogacy (2017) (the Task Force). Instead, the research finds that: women decide to act as surrogates out of the desire to help infertile couples and report being fulfilled by the experience; surrogates deny any coercion into surrogacy arrangements because of financial desperation; and surrogates do not report feeling the victim of market forces. (The research likewise counters concerns that children born from surrogacy arrangements are negatively impacted. According to the Task Force, “there are no formal, peer-reviewed research publications that conclude that children born through surrogacy have adverse psychological harms.”) In a Feb. 20, 2019 joint letter to Governor Cuomo written by a coalition of 14 women who had been surrogates, they explain:

There are few things as rewarding as seeing a parent hold a newborn baby for the first time and knowing that you brought that life into the world for them … It’s important that people know that the primary motivation for each of us, and for all the surrogates we’ve come into contact with, is helping a family, not financial reward. … Surrogacy today is a partnership—between the surrogate, the intended parent(s), doctors and nurses, and the surrogacy agency. We all get to know one another, see if we’re a good match, and then work together through this process of bringing a baby into the world.
The proposed CPSA models best practices and adopts high standards that have been established to protect both surrogates and IPs, and to ensure that if there is any power imbalance it is mitigated by regulation. For example, it requires that surrogates (and their spouses, if any) have independent legal counsel and major medical insurance coverage in place before embryo transfer, and mandates that the surrogate’s compensation be placed in escrow with an independent escrow agent prior to the occurrence of any medical procedures.

Fallacy That the CPSA Will Invite Custody Battles: Although the only sanctionable conduct under current New York law is compensated surrogacy, the statute nevertheless also declares all surrogacy arrangements void and unenforceable in a court. In fact, it specifically prohibits a court from considering a surrogate’s participation in a surrogacy agreement as adversely limiting her parental rights, status, or obligations in any action or proceeding involving a dispute between her and a genetic father or intended genetic mother. New Yorkers nevertheless participate in compassionate surrogacy arrangements. In practice, this has the unintended consequence of exposing New Yorkers to heightened uncertainty about parentage rights and obligations in the event of a dispute, and to avoidable financial risks. Thus, IPs are at a heightened risk of losing custody to a “birth mother” who changes her mind and wants to keep the child, and women acting as surrogates are at risk of forced parentage and financial obligations to support a child that was never intended to be her legal child.

New York’s current law further increases the risk of custody disputes by forcing IPs to go out-of-state to participate in a surrogacy arrangement. These interstate arrangements are far more complicated and less secure than their intrastate counterparts concerning legal parentage and custodial rights. For example, while interstate surrogacy agreements often contain choice of law provisions designating the law of the state in which the surrogate lives or gives birth, there remains a risk that a court will apply New York law and invalidate the agreement if there is a significant nexus to New York (e.g., the embryo transfer takes place in New York, or the surrogate prematurely delivers the child in New York). Interstate surrogacy arrangements also often mean that IPs have less contact with the surrogate and attend fewer medical appoints, which can make the bond between them more difficult to forge and maintain.

By establishing clearly defined procedures for obtaining judgments of parentage that become effective upon the birth of the child, the CPSA ensures enforcement of the intent of a surrogacy agreement and reduces the risk of a custody dispute.

Misplaced Fear That the CPSA Would Turn New York Into a Site for ‘Reproductive Trafficking’: Some opponents of the Bill contend that by reversing its anti-surrogacy law New York will “be viewed internationally as a new paradise for reproductive tourism—similar to a rogue state like Ukraine—where businesses profit from the sale of women and their
babies to well-to-do Americans and other foreigners.” See Letter to Governor Cuomo dated March 11, 2019, from The Center for Bioethics and Culture on behalf of Stop Surrogacy Now campaign. This thinly veiled scare tactic ignores the fact that as of 2018, 48 states and the District of Columbia permit the practice of compensated gestational surrogacy, by statute, case law, or judicial practice. See Gestational Surrogacy Law Across the United States: State-by-State Interactive Map for Commercial Surrogacy, Creative Family Connections. In other words, IPs pursuing surrogacy can be matched with surrogates in virtually every other state in the country; there is no need to flock to New York to access an otherwise unavailable family building option. Moreover, the Bill’s 90-day residency requirement not only enhances the opportunities for interaction between IPs and surrogates, it also serves to dissuade people from coming to New York solely for surrogacy purposes and prevents New York from becoming a surrogacy mill state.

By permitting compensated surrogacy arrangements that meet the Bill’s high standards, the CPSA would finally allow New Yorkers the opportunity to exercise the same reproductive rights and family building opportunities that are endowed to the citizens of 48 other states. No longer would infertile and gay male IPs who are citizens of New York be forced to go out-of-state for the opportunity to raise their own biological children, and no longer would they be subject to the unnecessarily heightened legal uncertainty, excessive financial burdens, and disrupted continuity of care that is the inevitable result of forcing New York IPs to switch to out-of-state medical providers. Moreover, the CPSA would validate the personal autonomy of New York women who are willing to serve as surrogates to carry and deliver a baby to be raised by loving parents.

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Law Firms Engaging in Non-Judicial Foreclosure Are Not “Debt-Collectors” Under FDCPA

By: Steven Herman¹ and Nick Brandfon²

On March 20, 2019, the Supreme Court of the United States ruled in the case of Obduskey v. McCarthy & Holthus LLP No. 17-1307 that a law firm conducting non-judicial foreclosure proceedings is not a “debt collector” under the Fair Debt Collection Practices Act, 15 U.S.C. 1692 et seq. (“FDCPA”), other than for a limited purpose.

Background

The FDCPA regulates the conduct of “debt collectors”. Among other things, it (a) restricts false, deceptive or misleading means in connection with the collection of any debt³, (b) prohibits conduct that is harassing, oppressing or abusive in connection with the collection of a debt⁴, (c) requires that if a consumer disputes the amount of a debt, a debt collector must cease collection until it obtains verification of the debt and mails a copy to the debtor⁵, and (d) prohibits certain unfair practices.⁶

Non-judicial foreclosure is a process by which creditors can enforce their security interests in real property outside of the court system. Non-judicial foreclosure is available in roughly half of the United States and, while the process varies based on state law, it generally involves a notice of default and notice of a public sale of the property being foreclosed on and, if the default is not cured after a period of time, a public auction of the property.

The Case

In 2007, Dennis Obduskey bought a home with a mortgage loan secured by the property he purchased. Two years later, Obduskey defaulted on the loan and the lender hired a law firm, McCarthy & Holthus LLP, to carry out a non-judicial foreclosure. McCarthy & Holthus LLP notified Obduskey that it had been engaged to commence foreclosure and disclosed the amount outstanding on the loan, and identified the creditor.⁷ Obduskey requested verification of the amount owed as required by §1692g(b) of the FDCPA.⁸ Rather than ceasing collection efforts and providing verification of the debt, McCarthy & Holthus LLP instituted a nonjudicial foreclosure. At issue in the case was whether McCarthy & Holthus LLP qualified as a “debt collector” within the meaning of the FDCPA.

As described above, the FDCPA prohibits or restricts certain actions by a “debt collector”. The list of proscribed activities is extensive and anyone who is a “debt collector” is subject to such restrictions. Section 1692a(6) of the FDCPA defines “debt collector” as “any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another.” Section 1692a(6) of the FDCPA further provides
that “[f]or the purpose of section 1692f(6) [emphasis added] of this title, [the term “debt collector”] also includes any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the enforcement of security interests.”

Section 1692f(6) of the FDCPA provides that the following actions by a debt collector are prohibited: taking or threatening to take a nonjudicial action to effect dispossession or disablement of property if (i) there is no present right to possession of the property claimed as collateral through an enforceable security interest; (ii) there is no present intention to take possession of the property; or (iii) the property is exempt by law from such dispossession or disablement.

The Supreme Court held that McCarthy & Holthus LLP was not a “debt collector” within the meaning of the FDCPA based primarily on the text of the statute because they were enforcing a security interest and thus were subject only to Section 1692f(6) of the FDCPA. The Supreme Court noted that the first sentence of the paragraph defining “debt collector” reads as follows:

“any person . . . in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or asserted to be owed or due another.”

and that the third sentence of the same paragraph, which the Supreme Court refers to as the “limited-purpose” definition provides:

“For the purpose of section 1692f(6) [the] term [debt collector] also includes any person . . . in any business the principal purpose of which is the enforcement of security interests.”

In the opinion, Justice Breyer for the Court noted that “foreclosure is a means of collecting a debt” and concluded the actions taken by McCarthy & Holthus LLP in pursuing a non-judicial foreclosure, which is both an attempt to collect a debt and an enforcement of security interests, did not subject it to the requirements and prohibition of the FDCPA other than Section 1692f(6). In deciding in this manner, the Supreme Court relied on that fact that the inclusion of the “limited-purpose” definition and particularly the word “also” supported McCarthy & Holthus LLP’s argument that a person in the business of enforcing security interests is only subject to the requirements of Section 1692f(6) because “[o]therwise why add this sentence at all?” In further support of its decision, the Supreme Court noted that the decision by Congress to treat non-judicial foreclosure differently from other debt collection may have been an effort to avoid conflicts with state non-judicial foreclosure laws and also pointed to the legislative history of the FDCPA, which suggests that the final version of the law was a compromise between subjecting the enforcement of security interests to the full coverage of the law and excluding such enforcement in its entirety.
Impact

Obduskey v. McCarthy & Holthus LLP makes clear that a lawyer or other person pursuing a non-judicial foreclosure is not subject to the full coverage of the FDCPA. In those cases, a person pursuing non-judicial foreclosure is subject to any applicable state laws related to non-judicial foreclosure. It should be noted however, that both the majority opinion and especially the concurring opinion by Justice Sotomayor leave open the possibility that Congress may revisit the FDCPA to specifically expand its reach to the enforcement of security interests. Additionally, the concurring opinion emphasized that the decision does not suggest that “pursuing nonjudicial foreclosure is a license to engage in abusive debt collection practices like repetitive nighttime phone calls; enforcing a security interest does not grant an actor blanket immunity from the Act.”

* * *

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3 15 U.S.C. 1692e
4 15 U.S.C. 1692d
5 15 U.S.C. 1692g
6 15 U.S.C. 1692f
8 Id.
10 Id.; quoting 15 U.S.C. 1692a(5).
11 Id.
12 Id.
13 Id.
14 Id.; Sotomayor concurring.
Maryland Commercial Receivership Act
Signed into Law
By: Lawrence D. Coppel

On April 30, 2019, the Governor of Maryland signed into law as Chapter 284 of the Laws of Maryland of 2019 the Maryland Commercial Receivership Act (“MCRA”) (new Title 24 to the Commercial Law Article). MCRA will go into effect on October 1, 2019. It is the product of a special committee of Maryland bankruptcy and real estate attorneys, and non-attorneys who have served as receivers. The statute was passed unanimously by both houses of the Maryland General Assembly.

Receiverships today are used in a variety of situations ranging from preserving commercial real estate from waste and capturing rents pending sale to a complete liquidation of a distressed operating business and a distribution of the liquidation proceeds to creditors. Closely related to a receivership is an assignment for the benefit of creditors (“ABC”), which is an insolvency proceeding initiated by a business that has appointed an assignee to take possession and control of its assets. MCRA will be applicable to both receivership and ABC proceedings.

As is the case with many states, Maryland case law on receiverships dates back to the early 1800’s and is derived from English common law dating back earlier. There is little case law and there was little statutory guidance in Maryland before MCRA regarding the appointment and powers of a receiver. Although court rules exist to fill in some of the gaps, the rules do not apply in all receivership proceedings and have not been updated in many years. The result of having little guidance has been uncertainty and lack of uniformity in court decisions regarding a receiver’s rights, duties and powers.

MCRA will apply to most commercial real estate receiverships, receiverships filed in connection with the dissolution of a corporation, and any other receivership in which a receiver is appointed to wind up the affairs of a business. Receiverships initiated by a Maryland governmental regulator are excluded from the scope of the statute unless the regulator or receiver appointed at the regulator’s request elects to have MCRA apply, or the court orders the application of the statute for cause shown. Insurance delinquency proceedings will not be subject to MCRA unless the Maryland Insurance Commissioner or receiver appointed at the Commissioner’s request elects to have MCRA apply.

Under MCRA the receiver is given the power to sell property free and clear of liens (provided certain conditions apply), assume or reject executory contracts, operate a business, avoid preferences and fraudulent transfers, and hire and compensate professionals. The statute requires court approval for some of the receiver’s actions, but not all. Unless the circumstances require otherwise, the court may issue orders only after notice and an opportunity for a hearing.

Except in the case of a real estate receivership, the appointment of a receiver will result in an automatic stay of all actions, with certain exceptions. A creditor may obtain relief from the stay for good cause. The court is granted the power to separately stay...
actions although it may not stay the action of a governmental regulator exercising its police or regulatory power.

Many of MCRA’s provisions were derived from the Uniform Commercial Real Estate Receivership Act, which was adopted by the National Conference of Commissioners on Uniform State Law in July, 2015. MCRA expanded the Uniform Act to include most commercial receiverships and ABCs.

Maryland is one of a handful of states that have enacted comprehensive receivership laws in recent years. Prior to adoption of the Uniform Act, comprehensive receivership statutes were enacted by the states of Washington and Minnesota. More recently, the states of Oregon and Missouri have enacted comprehensive receivership laws. The Uniform Act, which is applicable to commercial real estate receiverships, has been enacted by Michigan, Nevada, Tennessee and Utah.

With the MCRA in place, creditors and property owners in Maryland will have a clearer idea about how matters will proceed if they choose receiverships or ABCs in exercise of their rights and remedies.

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FEDERAL APPELLATE COURT AFFIRMS SECURED CREDITOR’S RETENTION OF A MORTGAGE LIEN WHERE MISTAKEN RELEASE WAS CANCELLED PRIOR TO BANKRUPTCY

The U.S. Court of Appeals for the Seventh Circuit allowed a secured creditor to retain its lien and therefore the proceeds from a sale of mortgage collateral, even after the secured creditor mistakenly released its mortgage lien of record. The case is Trinity 83 Development, LLC v. ColFin Midwest Funding, LLC (In re Trinity Development, LLC), slip. op. (7th Cir. March 1, 2019).

Trinity 83 Development, LLC, borrowed about $2 million from a bank to build an office building. The note and mortgage were sold to ColFin. ColFin’s loan servicer mistakenly recorded a document entitled a “satisfaction,” which stated that the loan had been paid and released the mortgage lien. The loan was still outstanding, and Trinity 83 continued to make payments to ColFin. Trinity 83 eventually defaulted, and ColFin discovered the mortgage had been mistakenly released. ColFin then recorded a cancellation of the satisfaction, and commenced mortgage foreclosure proceedings in state court. In response, Trinity 83 filed a Chapter 11 bankruptcy case in the Bankruptcy Court for the Northern District of Illinois.

Trinity 83 commenced an adversary proceeding against ColFin, contending that the “satisfaction” and release extinguished the debt and the mortgage lien, arguing it never consented to re-mortgage the property. ColFin moved for summary judgment against Trinity 83. Bankruptcy Judge Deborah L. Thorne agreed with ColFin, and held that the unilateral release was done in error and could be corrected unilaterally. Additionally, since no liens intervened between the recording of the release and the correction, ColFin’s mortgage lien retained first priority. Trinity 83 appealed the Bankruptcy Court’s decision to the federal District Court for the Northern District of Illinois. The property was sold to a third party during the bankruptcy case pursuant to Section 363 of the Bankruptcy Code while the Bankruptcy Court’s decision was on appeal to the District Court. Thereafter, the District Court affirmed Judge Thorne’s ruling. Trinity 83 then appealed the District Court ruling to the Seventh Circuit.

The Seventh Circuit affirmed the lower courts. The court rejected Trinity 83’s attempt to rely on In re Motors Liquidation Co., 777 F.3d 100 (2d. Cir. 2015), where a mistaken release of a UCC financing statement resulted in the avoidance of a $1.5 billion security interest. Here, unlike the General Motors case, the lender caught the mistake and corrected it prior to the bankruptcy filing. Since ColFin corrected the error prior to the filing of Trinity 83’s bankruptcy case, the debtor’s rights as a hypothetical lien creditor under 11 U.S.C. § 544(a)(1) did not come into play. ColFin maintained its first position lien when Trinity 83 went into bankruptcy. Another critical difference between this case and the GM case was, under Illinois law, a mistaken release of mortgage is ineffective as between the mortgagor and mortgagee.
If a secured creditor mistakenly releases its lien, it should correct the error as soon as possible. If it is diligent, the secured creditor may not be harmed by the inadvertent release, even if the borrower files for bankruptcy.

1 Lauren Newman is a partner in Thompson Coburn’s financial restructuring and bankruptcy practice. Thompson Coburn LLP represented ColFin Midwest Funding, LLP, throughout the case.
ARRC Proposes “Fallback” Language for New LIBOR-Based Loans: The Transition from LIBOR to New Replacement Rates Will Be a Bumpy Ride

ICE LIBOR. “The ICE LIBOR is the most widely used interest rate benchmark in the world. . . . U.S. dollar (USD) LIBOR is used as a reference rate for more than $200 trillion in notional amount of financial contracts in the cash [including debt] and derivatives markets . . ., roughly equivalent to 10 times U.S. Gross Domestic Product.”

Although most of these financial contracts are expected to mature by December 31, 2021, however, a substantial portion of these contracts will mature thereafter, when LIBOR is no longer expected to be officially available as an interest rate benchmark.

Moreover, new LIBOR-based loans continue to be made. 30-50% of “CRE/Commercial mortgage” loans, and 65% of interest rate swaps that are not exchange-traded, are based on the U.S. dollar (“USD”) LIBOR rate. About half of all U.S. adjustable rate consumer mortgage loans are LIBOR-based.

ARRC. The Alternative Reference Rates Committee (“ARRC”), which is sponsored by the Federal Reserve Board and the Federal Reserve Bank of New York, has issued its final version of model “fallback” language (dealing with the discontinuance of LIBOR) for new LIBOR-based loans that are syndicated or that include floating rate notes. The ARRC is expected to issue similar language shortly for business loans and securitizations.
SOFR. The ARRC is recommending that lenders choose the “Secured Overnight Financing Rate” (“SOFR”) as the successor to LIBOR. SOFR measures the cost of borrowing overnight, collateralized by U.S. Treasury securities, and is based on over $700 billion in actual daily transactions. However, there is no governmental requirement that lenders choose SOFR, and in fact some lenders intend to use the prime rate, the federal funds effective rate, or another index, instead of SOFR.

SOFR Volatility. One problem with SOFR is that it has a nasty habit of jumping far above its normal range at the end of each quarter. This is believed to occur as the result of greater demand by borrowers for overnight cash transactions, at the end of each quarter, in order to make their quarterly loan payments and manage their other liquidity needs. SOFR disruptions might also occur for other reasons, such as a failure to raise the U.S. debt ceiling, or action by the Federal Reserve to restrict the U.S. money supply. Borrowers may be distrustful of an interest rate like SOFR that has a history of such upward volatility.

SOFR Spot Rates or SOFR Averages Over Periods of At Least 1 Month. If SOFR is determined for a loan based on the rate at the end of each calendar quarter (which is when sharp increases in SOFR have historically occurred), then this will generally increase both the lender’s return from the loan, and the borrower’s interest expenses. However, instead of a SOFR rate on a single day (a “spot rate”), a borrower would generally prefer instead a SOFR rate that is averaged over a period of at least one month, which historically has been less volatile. According to the ARRC, the market has responded to this concern about SOFR volatility, since many SOFR-based financial contracts “that have been issued all use either a compound or linear average of SOFR over a fixed period of time [such as 1-6 months] as the floating rate paid under the terms of the contract, not a single day’s realization of SOFR.” However, 22% of the parties responding to the ARRC stated that it would be appropriate for SOFR to be determined for an entire interest period based on SOFR for only a single day. Therefore, parties should be aware of the possible use by a lender of a SOFR spot rate, and its potential risks for the borrower, given SOFR’s periodic upward volatility.

SOFR Alternatives – Forward-Looking SOFR, or Simple or Compound Backward-Looking SOFR. According to the ARRC, lenders and borrowers will theoretically be able to choose among a variety of SOFR alternatives, including 1) a forward-looking SOFR term rate (such as a rate for 1 month, 3 months, or 6 months), 2) a compounded average of daily SOFRs for an interest period in lieu of a term rate, or 3) a simple average of daily SOFRs for such period. However, the ARRC acknowledges that no market yet exists for a forward-looking SOFR term rate. The ARRC also admits that “there have been no compounded SOFR syndicated loans originated to date and therefore there is no standard methodology for referencing a compounded rate in syndicated loans at this time. Furthermore, at this time there is no standard set of ‘conventions’ for use of this rate in the loan market. In addition, many loan and securities systems cannot currently operationalize a daily compounded SOFR.”
SOFR Margin. Another issue is the amount of the additional margin that a lender should add to SOFR if the lender agrees to accept SOFR as the interest rate instead of LIBOR. SOFR is viewed as an interest rate that is practically risk-free, since it is determined based on transactions involving overnight loans fully secured by U.S. Treasury securities. Therefore, the ARRC proposed “fallback” language provides that a margin will be added to SOFR in order to give the lender a yield comparable to the yield that the lender would have received in lieu of LIBOR. According to the ARRC proposed “fallback” language, SOFR margin can be either a positive or negative number, unlike SOFR itself, which cannot be less than 0. However, the ARRC fallback language provides only general guidelines for calculating this margin. In the ARRC “Hardwired Approach” (providing less flexibility than the ARRC “Amendment Approach”) for syndications, margin is determined 1) by the Federal Reserve Board or a related entity, or, if this cannot be determined, then 2) pursuant to the ISDA definitions. However, it seems like a very heavy lift for the Fed or ISDA to determine SOFR margin in a manner that will be acceptable for a multitude of different future parties and transactions, and for a variety of future time periods; and some parties may object to “central planning.” In the ARRC “Amendment Approach” approach for syndications, such margin is determined in the future (when a “Benchmark Transition Event” or “Early Opt-In Election” occurs) by the Administrative Agent and the Borrower, subject to certain rights of the “Required Lenders,” but it is possible that these parties may disagree as to how to calculate such margin. Instead, if it is possible for the parties to agree to this margin when the “fallback language” is initially agreed to, then this may be better for all parties. Also, because of the unusual volatility of SOFR, a borrower or lender may also want, in certain cases (such as SOFR based on a spot rate), to negotiate a “collar” for SOFR, based on other more established and more stable interest rates, that would limit unusual interest rate increases or decreases in SOFR.

If Alternate Base Rate Replaces LIBOR, Then The Interest Rate Will Probably Increase. In most existing syndicated loan agreements, if LIBOR is unavailable, and quotes are also unavailable for the unsecured borrowing rate in the London interbank market, then the interest rate will be the “Alternate Base Rate’ or ABR [which] is typically defined in syndicated loan credit agreements as the highest of (x) Prime Rate, (y) Federal Funds Rate + 0.50% and (z) 1-month LIBOR + 1%.” Since the prime rate has traditionally been 300 points higher than LIBOR or the federal funds rate, therefore the replacement of LIBOR with the prime rate will probably result in a substantial increase in the interest rate, which will increase the borrower’s interest expenses. This would give borrowers a strong incentive to find an alternative, which may be the proposed ARRC fallback language, depending on how it is applied in the particular transaction.

Future ISDA Forms May Be Inconsistent With ARRC “LIBOR Replacement” Forms. If a loan also involves an interest rate swap, then this may cause some gear-grinding. The International Swaps and Derivatives Association, Inc. ("ISDA") is independently pursuing its own LIBOR replacement project, involving amendments to
the ISDA forms, and there will probably be inconsistencies between the ISDA and ARRC forms.

**Forward-Looking Term Rate:** For example, the ARRC has stated that “because standard derivatives are not expected to reference a forward-looking term rate, . . . borrowers in the loan market who execute hedges may prefer to remove Term SOFR (and adjust all of the corresponding cross references within the fallback language) in order to fall back to Compounded SOFR, the rate expected to be the same rate that becomes operative under ISDA’s standard definitions for derivatives. Note that other conforming changes may also be needed at the time a fallback is activated in order to maintain alignment with hedges.”\(^{19}\) On the other hand, as noted above, compounded SOFR has not yet been standardized, and some parties are currently unable to process compounded SOFR.

**LIBOR Replacement Prior To LIBOR Cessation:** Another potential inconsistency between the ARRC and ISDA forms is that the “Hardwired” ARRC form provides that LIBOR will be replaced, as the applicable interest rate, if the U.K. Financial Conduct Authority announces that LIBOR is no longer “representative.” This could occur if LIBOR is no longer an accurate reflection of the market, such as if a significant number of key banks decline to continue submitting LIBOR quotes. Some lenders and administrative agents are considering broadening this language so that LIBOR will be replaced if any binding governmental authority states that LIBOR is not “representative” or no longer can be used. Since it is not yet clear whether the ISDA forms will also provide that LIBOR may be replaced in the same way, “parties should understand that if ISDA does not include a similar provision and this third trigger results in a ‘Benchmark Replacement Date’ occurring with respect to the syndicated loans, a party seeking to effectively hedge LIBOR-based syndicated loans may be obligated (for contractual reasons) or may choose (for economic reasons) to terminate or amend its LIBOR-linked hedges to reference the benchmark replacement.”\(^{20}\)

**Securities.** The U.S. Mortgage Bankers Association has stated, “[I]n structured finance (CRE CLOs, conduits, and other CRE securitizations), there is a real possibility for basis mismatch between changes in the index and the timing of the changes in index in the underlying financial assets and the resulting certificates or bonds.”\(^{21}\) Currently, there is no solution for such mismatches, which are expected to continue even after December 31, 2021, the expected expiration date of LIBOR.

**Tax Issues Relating to Replacement Rates.** Significant tax issues need to be resolved in connection with ACCR’s LIBOR replacement project. For example, the ARRC has requested the IRS to issue guidance:

1. confirming that a loan modification, changing the interest rate from LIBOR to SOFR, or increasing the margin for SOFR in order to provide for an aggregate interest rate that is equivalent to the prior interest rate based on LIBOR (or a one-time payment to effectuate the same result), will not be a “significant modification” resulting in a taxable event pursuant to Section 1001 of the
Internal Revenue Code, or a deemed reissuance of a tax-exempt debt instrument;
(2) confirming that the taxpayer’s replacement rate valuation methodology is reasonable if it is “consistent” with the methodology of industry organizations such as ISDA;
(3) whether a payment from the issuer of a tax-exempt debt instrument to the holder constitutes interest for purposes of Section 103, and whether a payment from the holder to the issuer is treated as additional proceeds of the bonds;
(4) confirming a) that a mortgage loan held by a REMIC will continue to be a “qualified mortgage” pursuant to the REMIC rules even if LIBOR is replaced by SOFR or an alternative rate, and b) that such replacement is not a forbidden contingency;
(5) confirming that even though at least 2 interest rates [e.g., LIBOR and SOFR] will be applicable to a given loan, and that there are possible differences in the amount of interest payable pursuant to each of these rates, nonetheless such differences will not be original issue discount (“OID”) pursuant to the IRS rules for variable rate debt instruments;
(6) confirming the amount of interest expense that a foreign corporation may deduct, pursuant to Section 1.882-5, against its effectively connected income;
(7) confirming the extent to which withholding requirements will apply to payments, to non-U.S. persons, of “fixed or determinable annual or periodical” income under Sections 1441 and 1442;
(8) confirming that for taxpayers that have integrated both debt instruments and derivatives into synthetic debt instruments under Section 1.1275-6, any LIBOR replacement will not cause a deemed reissuance (of the debt or the hedge) that could cause a “leg out,” giving rise to a deemed disposition of the synthetic debt instrument for its fair market value and an inability to “leg in” to a new synthetic debt instrument for 30 days; and
(9) whether a change in discount rates (for the purpose of valuation of loans pursuant to Section 475) would constitute a “change in treatment of a material item” for the purposes of Section 446, and would trigger the need to obtain the consent of the IRS for a change in the method of accounting, pursuant to Section 446.22

It is unclear whether the IRS is willing or able, on the ARRC’s tight schedule, to provide the detailed guidance requested by the ARRC.

CFTC Regulatory Issues and Exemptions Relating to Replacement Rates. In addition, the ARRC has also requested the Commodity Futures Trading Commission (“CFTC”) and other regulators to confirm the following:

(1) Non-cleared swap margin rules still do not apply to derivatives contracts that were entered into prior to the effective date of the clearing rules, and are therefore “grandfathered,” even if such “grandfathered” derivatives contracts are amended in the future to provide either that LIBOR will be replaced by SOFR (or another replacement rate) if LIBOR is permanently discontinued, or that LIBOR
is being replaced as of the date of the amendment. Further, inclusion of any such amendment in a "grandfathered" derivatives contract does not require counterparties to conduct a new analysis of such contract’s treatment under the swap margin rules. For future reference, in general, derivatives contracts that were entered into prior to the effective date of a given law or regulation (such as the clearing rules), and are therefore “grandfathered,” are hereinafter called “Grandfathered Derivatives”.

(2) CFTC mandatory clearing and trade execution requirements do not apply either to Grandfathered Derivatives that include any such amendment (providing for replacement of LIBOR), or certain new derivatives contracts based on SOFR or another replacement rate, absent a new CFTC clearing mandate determination; and inclusion of any such amendment in Grandfathered Derivatives should not require counterparties to conduct a new analysis of their contract’s treatment under the CFTC’s clearing rules.

(3) CFTC swap dealer business conduct rules do not apply to Grandfathered Derivatives that include any such amendment (providing for replacement of LIBOR); and inclusion of any such amendment in an existing derivatives contract does not require counterparties to make new disclosures or perform new obligations under these rules.

(4) CFTC swap trading relationship documentation and confirmation requirements do not apply to Grandfathered Derivatives that include any such amendment (providing for replacement of LIBOR). With respect to existing derivatives contracts that have not been amended to provide for a post-LIBOR rate, market participants will not be required to update their swap trading relationship documentation and issue new confirmations if such contracts are amended (to provide for LIBOR replacement) via a multilateral protocol. Also, market participants may comply in good faith with the requirement under the CFTC portfolio reconciliation rules to “immediately” resolve discrepancies between trades.

(5) CFTC real-time reporting obligations do not apply to either Grandfathered Derivatives or existing derivatives contracts that have been amended to provide for a post-LIBOR rate. Good-faith compliance, with certain CFTC regulatory reporting and recordkeeping requirements, is permitted for both Grandfathered Derivatives and existing derivatives contracts that have not yet been amended to provide for a post-LIBOR rate.

(6) Amendments (regarding replacement of LIBOR) to either an end user’s derivatives contracts or LIBOR-linked loan agreements, debt instruments and other agreements or transactions, do not affect such end-user’s ability to rely on the clearing exception and uncleared margin exemption for swaps hedging or mitigating commercial risk.23

Likewise, it is unclear whether the CFTC or other regulators are willing or able, on the ARRC’s tight schedule, to provide the detailed guidance requested by the ARRC.
Antitrust Issues. ISDA is involved in a U.S. Department of Justice business review letter process relating to an antitrust review of calculation methodology.\textsuperscript{24}

Foreign Regulators. Since a significant portion of LIBOR-based debt instruments are and will be held by foreigners, the consent and guidance of foreign regulators may be necessary, in connection with the proposed replacement of LIBOR, in such instruments, with SOFR or other rates.

Legal Notices Must Be Given to Vast Multitudes in Connection With LIBOR Replacement and Other Related Events. According to the ARRC documents, various lenders, administrative agents, or servicers may be obligated to give legal notices, with little to no advance warning, to many parties within a short period of time.\textsuperscript{25} Such notices may disclose (i) the occurrence of a trigger event, including an early opt-in election, as applicable (and the related “Benchmark Replacement Date” and “Benchmark Transition Start Date”), (ii) the implementation of any Benchmark Replacement, (iii) the effectiveness of any “Benchmark Replacement Conforming Changes,” (iv) the removal or reinstatement of any Term SOFR tenor (“Hardwired Approach” only) and (v) the commencement or conclusion of any “Benchmark Unavailability Period,” i.e. when the loans would accrue interest at the “Alternate Base Rate.”\textsuperscript{26}

Other Borrower Changes to LIBOR Replacement Documents. Borrowers should bear in mind that various “lender-oriented” provisions, that lenders have traditionally required in connection with LIBOR-based loans, such as break-funding, increased costs, and illegality, may need to be revised or removed if and when LIBOR is replaced as the applicable reference rate.\textsuperscript{27}

Recent Surge in Borrower Complaints About the Servicing of Securitized Loans.

Borrowers have recently become much more vocal about raising a variety of complaints relating to the servicing of securitized loans.

Cash Management May Be Required For Healthy Borrowers That Have Made All Loan Payments. A lender’s right to require “cash management” of the mortgaged property, by means of a “hard” lockbox,\textsuperscript{28} may result in (from the borrower’s perspective) unnecessary expenses, excessive cash reserves, below-market interest on the cash, and delays in getting cash from the mortgaged property. How could this happen? In theory, the securitized loan documents should protect bondholders by preventing cash proceeds of the mortgaged property from being released to the borrower if there is a risk of default. Therefore, if “debt service coverage ratio” (“DSCR”) or other financial requirements are not met, a servicer may have the right, for example, to activate a “hard” lockbox that allows rents and other proceeds from the mortgaged property to be collected directly by the servicer. These funds are then used to pay property expenses, or held as reserves, with any remaining net surplus released to the borrower only if certain thresholds are met. Some borrowers have complained that they been denied access to the net cash flow from their mortgaged property based on their failure, for example, to meet a DSCR requirement that is calculated in a
manner that is much more strict than the generally accepted “market” DSCR requirement. For example, the securitized loan documents may artificially lower the DSCR for a particular property by calculating the DSCR based on the amortization of the loan over 30 years, even if the loan documents actually provide for interest-only payments (resulting in lower monthly expenses for the borrower). Some servicers similarly depress the applicable DSCR by refusing to credit the borrower for rent payments made by a key tenant while its store is closed in order to make necessary improvements. Another way that the DSCR may be artificially lowered is if the servicer has the discretion, in determining “Underwritten Operating Income,” to revise rental rates, occupancy rates, and other accounting categories to the least of actual, market, or underwritten rates. Therefore, even if a property is beating the market averages for these categories, the DSCR can still be determined as if the property is merely average. This may be devastating if the local market occupancy and rental rates have slumped, but the mortgaged property is actually a well-located “trophy” that can be expected to hold its value, and has had a demonstrated history of generating a strong net cash flow. Finally, it is hard for a borrower to make its case, for restoring its access to the net cash flow from its property, when the securitized loan documents provide, as they typically do, that the servicer’s calculation of the DSCR for a given property is binding unless there is a “manifest error.”

In recent years, additional triggers for a “hard” lockbox have been added to securitized loan documents, such as (1) a decline in the net worth of the borrower’s principals, (2) bankruptcies of key tenants, and (3) the looming expiration dates of major leases. Servicers are also unhappy with the burden of monitoring multiple performance thresholds, such as the net worth of the borrower’s principals, which is typically not easy to calculate precisely.

Delays in Obtaining Servicer Consents. Many borrowers of securitized loans have had difficulty, after the closing, obtaining necessary consents from their loan servicers. Borrower requests may involve seriatim applications to, and lengthy reviews by, the primary, master, and special servicers, as well as the B-piece investor or controlling classholder.

Recently, pooling and servicing agreements have been revised to accelerate this process, so that master servicers are authorized to approve routine borrower requests, such as reserve releases and straightforward approvals for leases and budgets. On the other hand, major consents (e.g., loan assumptions by buyers, or any change of the property manager) still must be reviewed and authorized by the special servicer and controlling classholder for their respective approvals.

Obviously, servicers are not able to process borrower requests without the complete package that is reasonably required by servicers in order to do their jobs. On the other hand, servicers should specify in advance what must be provided by borrowers to servicers, and alert borrowers about any missing items.
Ideally, each servicer should clarify what steps must be taken by the borrower, and what fees and delays should be expected by the borrower. In many cases, there are duplicative efforts with the primary, master and special servicer each analyzing the borrower request; and, in such cases, approval by the master servicer does not mean approval of the request if the special servicer and controlling classholder have not also approved.

**Excessive Servicing Fees.** Some borrowers feel that they are being “nickel and dimed” by servicing fees for ordinary requests, such as for lease approvals, nondisturbance agreements, property management agreements, reserve disbursements, etc. As a result, Wells Fargo has announced that, while it will continue to collect these fees for existing CMBS loans, it will waive them for future ones.31

In some deals, special servicers have required substantial payments from borrowers as a precondition for the issuance to borrowers of major consents. This has made some borrowers very angry.32

**How Foreclosing Lenders Can Avoid Waiving Interest.**

Some courts have ruled that, by virtue of delays by lenders during foreclosure actions, such lenders have waived all interest that has accrued during the delays.33 Although this may occur solely as the result of a lender’s inaction, it is easy to see how significant delays may occur for reasons that are not the fault of the lender. A borrower may seek a loan modification, but then fail to submit an application. A lender’s employee may call a borrower to inform a borrower that the borrower’s application is incomplete, or incorrect, and leave a message, or messages, which are not returned. For some borrowers, it is in their interest to delay the foreclosure process as long as possible, if they are not making payments on their loan or their property taxes, but they are still living in the mortgaged property. Finally, when the foreclosure action is on the brink of being completed, the borrower’s attorney may make a motion to require the lender to waive its accrued interest on account of delays in the foreclosure action, in order to eliminate or minimize a lender’s right to a deficiency judgment.

Therefore, a lender should also obtain an estoppel from the borrower, in connection with any loan modification, confirming the aggregate amount that is due and payable as of the date of the loan modification. Such estoppel should include an itemization of each specific amount that is owed to the lender, including the unpaid principal balance, and accrued and unpaid interest, fees and other charges. The estoppel should also document the efforts taken by the lender in connection with any loan modification, and the facts demonstrating that the lender was not delinquent in asserting its rights. This may be helpful if the borrower asserts, at a later date, that the lender was responsible for any delay in enforcing its rights, and that the lender has therefore waived its right to receive interest or other amounts accruing during the alleged delay.
New Tribar Committee Report on Legal Opinions Regarding Limited Partnerships

The Tribar Opinion Committee has issued a new report entitled “Third-Party Closing Opinions: Limited Partnerships,” which will be an invaluable resource. For example, suppose you are drafting an opinion that a Delaware limited partnership (“LP”) is “validly existing.” You have a good standing certificate from the Delaware Secretary of State. Isn’t that enough to confirm the LP’s existence? The Tribar report points out that the statement in the Delaware good standing certificate is limited by the caveat stating “so far as the records of this office show.” This means that the Delaware good standing certificate provides no assurance regarding the satisfaction of the necessary preconditions for the LP’s existence, pursuant to Delaware law, that do not involve a filing with the Delaware Secretary of State. Therefore, the “validly existing” opinion should be given only if the opinion giver has received (1) a good standing certificate from the Delaware Secretary of State, (2) a counterpart of the signed current certificate of limited partnership (complying with the LP Act) certified by the Secretary of State, and (3) a counterpart of the current partnership agreement that has been signed by the necessary parties.

Uncertainty of Choice of Law in the Age of the Internet and Multistate Banking.

The ease of internet loan applications has triggered defenses by “out of state” borrowers who travel to the lender’s state for the closing, sign documents that apply the law of the lender’s state, but then assert defenses based on the law of the borrower’s home state. In Moore v. Fischer, a prospective borrower, while surfing the Internet at home in New Jersey, saw an ad for consumer loans, with a 180% “annual percentage rate.” The borrower submitted an online application from her New Jersey home, and was later called by the lender to say that the loan had been approved. The borrower then drove to the Delaware office of the lender and got a $3,000 loan secured by her 2007 Toyota. The loan documents applied the law of the state of execution of the loan documents – i.e., Delaware law. When the borrower defaulted, the lender repossessed the Toyota. The borrower then sued, alleging that the lender had violated the 30% maximum criminal usury limit in New Jersey. The appellate court ruled that the borrower had the right to file an amended complaint, based on the above facts, and to provide evidence that application of Delaware law “would be contrary to a fundamental policy of” New Jersey.

A Loan Sale Contract, Deferring the Accrual of a Loan Buyer’s Rights Against the Loan Seller, Violates Public Policy Against Extension of Statutes of Limitations.

In Deutsche Bank Nat’l Tr. Co. v. Flagstar Capital Markets Corp., the court refused to apply the provisions of a contract of sale (between the seller/loan originator of loans and the buyer) that would have delayed accrual of the claims of the buyer more than six years after the applicable closing date pursuant to such contract, which was the date that the seller/loan originator made allegedly false representations as to
the loans. The contract provided that “Any cause of action against the Seller relating to or arising out of the breach of any representations and warranties . . . shall accrue as to any Mortgage Loan upon (i) discovery of such breach by the Purchaser or notice thereof by the Seller to the Purchaser, (ii) failure by the Seller to cure such breach, substitute a Qualified Substitute Mortgage Loan or repurchase such Mortgage Loan . . . and (iii) demand upon the Seller by the Purchaser for compliance with this Agreement.”\(^{39}\) The buyer's sole remedy was the seller's obligation to cure or repurchase a non-conforming loan. The court ruled that there was no substantive condition precedent in the contract that might have delayed the accrual of the “six year” statute of limitations, and to the extent that the parties otherwise intended to delay the commencement of the limitations period, their attempt to do so was inconsistent with New York law and public policy.

Are there still any grounds, pursuant to New York law, for the buyer of a loan portfolio to make a claim, against the seller of the loans, more than 6 years after the effective date of the seller's misrepresentations regarding such loans? In LDIR LLC v. DB Structured Prods. Inc.,\(^ {40}\) the New York Appellate Division has ruled that the transferee of a portfolio of loans was entitled to plead a claim, against a loan seller, that arose more than 6 years after the date of the seller's original misrepresentations. In the LDIR LLC case, a seller of loans discovered, after the closing of the sale, that it had made misrepresentations regarding the loans. The contract of sale provided that the seller was required to give notice only to itself of such misrepresentations. The trustee (that acquired such loans) sued the seller for failing to give post-closing notice to the trustee of the fact that the seller had discovered, post-closing, its breach of its representations. The seller defended on the ground that it was literally required by the contract of sale to give notice only to itself, and not any other party. The New York Appellate Division ruled that the trustee was entitled to amend its complaint to include a claim that the contract of sale implicitly required notice of such breach to be given also to the trustee, since it would be nonsensical for the contract of sale to be interpreted that the seller was obligated to give notice only to itself of its own breach. A New York trial court has also upheld similar “failure to notify” claims against loan sellers that failed to notify buyers of the sellers’ discovery of their own misrepresentations, despite the prior agreement by such sellers to provide such notice.\(^ {41}\)

**U.S. Supreme Court Rules That a Law Firm Bringing A Nonjudicial Foreclosure is Not a “Debt Collector” under the FDCPA**

The U.S. Supreme Court ruled in Obduskey\(^ {42}\) that a law firm bringing a nonjudicial foreclosure is not a “debt collector” under the Fair Debt Collection Practices Act (“FDCPA”), unless it makes false or illegal threats to dispossess a debtor. What about judicial foreclosure actions? Many practitioners believe that judicial foreclosure actions should be treated the same way if the plaintiff lender waives its right to a deficiency claim against the debtor.\(^ {43}\) However, the U.S. Supreme Court recently denied certiorari in Maxwell & Morgan, P.C. v. McNair,\(^ {44}\) which raised the question of whether the FDCPA applies to foreclosures that do not seek any payment from a
consumer. Also, the National Consumer Law Center has taken the position that the FDCPA still applies to judicial foreclosures, since, “unlike non-judicial foreclosures, judicial foreclosure judgments typically have a direct effect on the deficiency claim by conclusively establishing the amount of the monetary debt the borrower owes.”

This article provides merely summary general information that should not be relied upon, and does not provide any specific legal advice for the benefit of any particular client or any other person.

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3 “Second Report” at 2 (Table 1) (ARRC March 2018), available at https://www.newyorkfed.org/arrc/index.html; Ira Jersey & Angelo Manolatos, “Transitioning to SOFR, the new rate benchmark” (Bloomberg Feb. 11, 2019).

4 “Interim Report and Consultation” at 7, Table 1 (ARRC May 2016), available at https://www.newyorkfed.org/arrc/index.html


6 “ARRC Recommendations Regarding More Robust Fallback Language For New Issuances Of LIBOR Floating Rate Notes” (ARRC April 25, 2019) and “ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” (ARRC April 25, 2019). See also “ARRC Consultation[:] New Issuances Of LIBOR Securitizations” (ARRC Dec. 7, 2018). Each of the foregoing is available at https://www.newyorkfed.org/arrc/index.html


8 John Heltman, “Libor is going dark in 2021, and some banks aren’t ready” (Am. Banker Dec. 30, 2018);

9 Matt Levine, “Libor’s Replacement Is a Little Too Real” (Bloomberg Feb. 13, 2019);


11 “ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 35 (ARRC April 25, 2019).

12 “ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 2, 13, and 24 (ARRC April 25, 2019).


14 “ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 22-24 (ARRC April 25, 2019).

15 “ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 6 (ARRC April 25, 2019) (see the definitions of “Benchmark Replacement” and “Benchmark Replacement Adjustment”).
“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 6 (ARRC April 25, 2019) (see the definition of “Benchmark Replacement Adjustment”).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 10-11 (ARRC April 25, 2019) (see the definition of “Benchmark Replacement Adjustment”).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 3-4 (ARRC April 25, 2019).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 21, 37 (ARRC April 25, 2019).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 15-16, 33-34, 37 (ARRC April 25, 2019).


“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 30 (ARRC April 25, 2019).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 5, 10, 31 (ARRC April 25, 2019).

“ARRC Recommendations Regarding More Robust Fallback Language For New Originations Of LIBOR Syndicated Loans” at 32 (ARRC April 25, 2019).

“A ‘hard lockbox’ is a lockbox account, maintained with the lender or its servicer, to which all rents and other income from the mortgaged property are directly paid by the tenants and other obligors. For more details about ‘hard lockboxes,” see Boyd, Real Estate Financing §§ 5.02[14][e], 6.02[7][b][iii-iv], 6.02[30][e], 6.03[2], 17.02[2][c][ii], 17.02[23], 22.02[4][g] & 22.09[2][f] (Law Journal Press, 44th ed. 2019).


“Commercial Real Estate” (Wells Fargo), available at https://www.wellsfargocom.com/financing/real-estate/cmbs-news/


Greenpoint Mtge. Corp. v. Lamberti, 155 A.D.3d 1004, 66 N.Y.S.3d 32 (2d Dept. 2017) (lender delayed, for 3 years, its filing of a request for judicial intervention in the foreclosure action, resulting in a waiver of interest during such delay). See also Citicorp Trust Bank, FSB v. Vidaurre, 155 A.D.3d 934, 65 N.Y.S.3d 237 (2d Dept. 2017) (four years of interest was waived from 1) the date of an appellate court affirmance of summary judgment for the lender until 2) the date of the referee’s report); BAC Home Loans Servicing, L.P. v. Jackson, 159 A.D.3d 861, 74 N.Y.S.3d 59 (2d Dept. 2018) (lender waived 4 years of interest during a foreclosure action because of the lender’s 4 year delay in filing a request for judicial intervention requesting a settlement conference).
35 Id. at 1112 n. 24.
36 Id. at 1112-13.
37 2018 WL 4868289 (N.J. Super. Ct. 2018) (this opinion stated that it “shall not ‘constitute precedent or be binding upon any court.’”).
39 32 N.Y.3d at 144-45.
41 In Fed. Hous. Fin. Agency for Fed. Home Loan Mortg. Corp. v. Morgan Stanley ABS Capital I Inc., 59 Misc. 3d 754, 73 N.Y.S.3d 374 (Sup. Ct. 2018), the court likewise ruled that the trustee for the securities holders was entitled to make claims against the “Morgan Stanley” securitizers of certain residential mortgage-backed securities, on account of the failure of these securitizers to give notice to the trustees of breaches of representations and warranties after these securitizers had become aware of such breaches. A six year statute of limitations was applied, so that the trustees could make claims, based on a “failure to give notice” basis, only with respect to such breaches that such securitizers became aware of during the six year period prior to the filing of the trustee’s complaint.
43 This was the consensus of the panelists at the ABA program entitled “Foreclosure and the FDCPA: A Look at Obduskey v. McCarthy & Holthus LLP” (ABA Bus. Law Sec., Spring 2019).
UNIFORM COMMERCIAL CODE OPINIONS IN REAL ESTATE FINANCE TRANSACTIONS

Joint Drafting Committee comprised of William B. Dunn (Primary), Edward N. Barad, Kenneth P. Ezell, Jr., Catherine T. Goldberg, R. Marshall Grodner, Raymond S. Iwamoto, Kenneth M. Jacobson, Robert J. Krapf, Edward J. Levin, Charles L. Menges, David L. Miller, Laurence G. Preble, Lydia C. Stefanowicz, Steven O. Weise, Sterling Scott Willis, and Lawrence J. Wolk

This Report provides basic guidance for opinion practitioners in real estate finance transactions to consider in giving and reviewing opinions when there is a personal property security interest governed by the Uniform Commercial Code.

ABA RPTE CONSERVATION EASEMENT TASK FORCE REPORT:
RECOMMENDATIONS REGARDING CONSERVATION EASEMENTS AND FEDERAL TAX LAW

ABA Conservation Easement Task Force: W. William Weeks (Chair), Turney Berry, Jonathan Blattmachr, Jason Havens, Nancy A. McLaughlin, James Slaton, Steve Swartz, and Philip Tabas

In October 2015, the American Bar Association’s Real Property, Trust and Estate Law (RPTE) section convened a Conservation Easement Task Force. The objective of the Task Force was to provide recommendations regarding federal tax law as it relates to conservation easements. This Report is the culmination of the Task Force’s work. Part I of the Report is an Executive Summary of the Task Force’s recommendations. Part II provides the background necessary to understand the Task Force’s recommendations. Part III briefly sets forth the Task Force’s comments on the Tax Cuts and Jobs Act of 2017 as it relates to charitable contributions in general and conservation easement donations in particular. In Part IV, the Task Force recommends that the Treasury publish safe harbor provisions that would be common to most conservation easements. Part V sets forth the Task Force’s recommendations regarding amendments and discretionary consents, the inconsistent use regulations, and furthering transparency in conservation easement administration. Part VI discusses issues surrounding valuation of conservation easements. Part VII contains a brief comment on syndicated conservation easement transactions. Part VIII is the Task Force response to certain proposals the Treasury Department made (most recently in 2016) to change conservation easement law.

Appendix A sets forth the “perpetuity” requirements of § 170(h) and the Treasury Regulations. Appendix B offers specific language to facilitate the preparation of key safe harbor provisions.

BEWARE-bnb?: ADAPTING THE REGULATORY APPROACH OF COMMUNITY ASSOCIATIONS TO RESIDENTIAL SHARING & ZONING TRENDS

J. Patrick Bradley

This Article discusses current trends in the regulation of residential sharing activity by zoning authorities and community associations, and it highlights recent municipal approaches that address short-term rentals. This Article argues that an opportunity exists for community associations to confront residential sharing activity by using current zoning trends as a guide to formulate association-specific regulatory strategies, and it cautions that reliance on existing covenants may not adequately regulate short-term rental activity.
THE ENIGMA OF END-OF-LIFE DECISIONS IN ADVANCE DIRECTIVES

Gregory S.C. Huffman

This Article discusses advance health-care directives and the subjective, personal choices one must make for a future unknown situation. The Article first examines legal issues created by the various available types, and then moves into religious and philosophical views affecting a person’s end-of-life choices. Issues involving a person’s health, age, and financial and emotional situation are also discussed. Because a directive does not normally go into effect until a person can no longer make a medical decision, the Article also discusses quality-of-life issues arising from a minimally conscious state, a vegetative state, a locked-in state, and coma. There is then a discussion of the default position courts and medical providers take when no advance directive has been filled out, and the risks of leaving a person’s end-of-life decisions to an agent. This Article concludes that an advance directive tends for most to be an enigma because so few have ever thought out the many complex issues raised by this type of document.

PORTABLE RECIPROCITY: A WAY TOWARDS A BLOCKCHAIN AGNOSTIC WORLD TO FACILITATE CROSS-BORDER REAL ESTATE TRANSACTIONS

Raymond L. Tran

The application of blockchain technology to securely trade real estate assets and raise funds across borders is inevitable; but maximizing its value relies on widespread adoption, which in turn relies on platforms becoming blockchain agnostic. This Article proposes implementing portable reciprocity as the first step towards enabling a regulated, cross-border REtech world. First, this Article reviews the development and practical applications of cryptocurrency and blockchain technology and how that technology enabled smart contracts to emerge. Second, this Article analyzes the impact of blockchain and smart contracts to general real estate transactions and to cross-border real estate transactions, creating the need for regulations to maximize the technology’s full value and application. Third, this Article examines portable reciprocity as a solution to the needs raised. Finally, this Article concludes with suggestions for next steps and a regulatory snapshot of how governments are currently treating cryptocurrency and blockchain technology.
The Business Planning Group addresses all manner of trust and estate issues that affect closely held business owners. The Business Investment Entities, Partnerships, LLC’s and Corporations (the “Business Entity” committee) looks at tax and non-tax issues related to the selection and structuring of entities that coordinate with the estate planning goals of the business owners. The Estate Planning and Administration for Business Owners, Farmers and Ranchers (the “Business Owners” committee) focuses on issues that influence the personal planning for business owners and the administration of trusts and estates that own those businesses.

Business Planning Group members presented compelling topics at the National CLE meeting in Boston. Our members will present select portions from those programs as eCLEs in the coming year. The BPG continues to monitor the proposed regulations and guidance Washington and will offer comments on the regulations and guidance that may affect business owners. Our regular Business Planning Group calls will resume in September 2019 to generate lively discussion and provide information and context for lawyers representing closely-held business owners.
Employee Benefits and Executive Compensation Group
Group Co-Chairs: John Paliga and Karen Suhre
Group Co-Vice Chairs: Elizabeth Leight and Lori Oliphant

The Employee Plans & Executive Compensation Group is comprised of 249 attorneys with an interest in or focus on employee benefits, ERISA and executive compensation issues. We have six substantive committees: Fiduciary Responsibility, Administration, and Litigation; Welfare Benefit Plans; Plan Transactions and Terminations; Qualified Plans; Non-Qualified Deferred Compensation; and IRAs and Plan Distributions.

Our group hosts six free group calls per year, with each committee hosting an informal presentation on current developments. In November of 2018, the Plan Transactions and Terminations Committee, led by Harold Ashner and Damarr Butler, gave a comprehensive update on PBGC activity and recent case law. In January of 2019, the Qualified Plans Committee reviewed current developments. In March of 2019, the Non-Qualified Deferred Compensation Committee, led by Doreen Lilienfeld and Victoria Zerjav, presented a program covering new IRC 83(i), IRC 162(m) issues, non-competes and other current developments. In April of 2019, the Fiduciary Responsibility, Administration, and Litigation Committee, led by April Goff & Peter Kelly, presented on current ERISA fiduciary topics. We are looking forward to our next group call on May 31, 2019 with a discussion on current developments led by the IRAs & Plan Distributions Committee, and a program focusing on COBRA on June 28, 2019, led by the Welfare Benefit Plans Committee.

At the 2018 Joint Fall CLE Meeting with the Section of Taxation in Atlanta, Georgia, Russell Gully and Harold Ashner from our group presented with their Tax Section counterpart subcommittees. At the recent Spring CLE Meeting in Boston, Karen Suhre, John Paliga, Jose Jara and Krisa Benskin presented on “Everything We Wish Law Firms Knew about their Own Benefit Plans.”

Members of our group have authored several eReport articles recently. In May of 2018, Krisa Benskin wrote “Fiduciary Rule Vacated: Transition Rule Extended.” The Winter, 2019 Edition includes three articles from members of our group: “Proposed Regulations Liberalize Requirements for 401(k) and 403(b) Plan Hardship Distributions” by Russell G. Gully; “Annual Pension Benefit Guaranty Corporation Updates” by Lany L. Villalobos; and “ERISA: Thou Shall Not Pay Excessive Fees!” By José M. Jara. April Goff serves as an editor of the eReport. In Probate & Property, May/June 2018 Edition, Tara Silver-Malyska wrote “Health Care Reform and Expatriate Health Benefits.” The IRAs and Plan Distributions Committee (Russell Gully, Marc Purintin, David Valente & Krisa Benskin) have prepared a comprehensively updated set of FAQs on “Planning With Retirement Benefits” to replace the content currently on the RPTE webpage.

Our group is part of the Joint Committee on Employee Benefits (JCEB) which also includes the ABA Tax, Labor, Business, Health and TIPS Sections. Several group members participated in and presented at JCEB meetings with government representatives at the Annual Government Invitational in Baltimore in March of this year.
Elizabeth Ysla Leight facilitated the JCEB Technical Agency Meetings that included involvement by the various ABA Sections with several government agencies in Washington D.C. this May, and several other group members had the opportunity to attend those meetings. The JCEB also presents many CLE Programs that members of our Group have been involved in. Linda Mendel co-chaired the JCEB Health & Welfare Plans National Institute in October of 2018. Peter Kelly co-chaired the JCEB Fiduciary Institute on April 4, 2019 in Washington, D.C.; Frank Palmieri and David Cohen moderated panels on that program. Several group members, including Courtney Vomund and Tara Silver-Malyska, have organized and presented JCEB eCLE programs as well. Ideas for new CLE programs are always welcome!

Several members of our group are fellows of the American College of Employee Benefits Counsel, which is also part of the ABA Joint Committee on Employee Benefits. John Paliga co-chaired the 2019 Ellen A. (Nell) Hennessy Employee Benefits Moot Court competition sponsored by the College, which was held on February 23, 2019 at Catholic University in Washington, D.C. Several of our members participated in the competition as judges, and Damarr Butler coached the Georgetown team, which won best brief and best oralist.

We encourage anyone with an interest in employee benefits or executive compensation issues to dial in for our upcoming calls on May 31 and June 28. All are welcome to sign up for our group on the ABA Connect website. Please reach out to group chairs John Paliga or Karen Suhre if you are interested in getting involved in any of our activities or if you have ideas for new programs, articles or activities.