SUMMER 2009 VOLUME 2 NUMBER 2

ABA REAL ESTATE QUARTERLY REPORT

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SECTION OF REAL PROPERTY,
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AMERICAN BAR ASSOCIATION

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SUMMER 2009 **VOLUME 2, NUMBER 2**

Quarterly Report on Current Developments in Real Estate Law

April 1 through June 30, 2009

Sponsor:
ABA Section on Real Property, Trust and Estate Law
American Bar Association

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Statement of Editorial Policy:

This publication is intended to provide experienced real estate practitioners with information on recent decisions and writings affecting real estate practice. Although there are occasional reports of administrative or legislative decisions or related matters, the primary focus of the Report is on appellate court decisions. Members of the Committee are assigned to review all reported decisions in standard reporting services received in their libraries prior to the close of the stated reporting period. They forward their summaries those cases that they deem to be of interest to a nationwide audience. They forward their summaries and copies of the cases to the editor, who substantially edits the summaries and frequently adds comments.

The editors hope to provide a comprehensive review of significant new developments, but obviously they cannot warrant that every new case is reported. Further, readers should be aware that the editors specifically eliminate from coverage cases that are of interest primarily to lawyers within a given state. Thus, significant interpretations of state statutes or constitutions, even if of critical importance to local practitioners, may not appear in the Report. Readers should rely upon update services provided by state or local sources to stay current on such developments.

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*The editor frequently revises reports and occasionally adds comments not submitted by a contributor. Time constraints do not permit contributors to review and ratify such changes. Therefore, inaccuracies in the reports and the content of many comments are the responsibility of the editor, and not necessarily of the identified contributor.

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APPRAISERS; DUTY OF CARE; DUTY TO HOME BUYERS: Arizona court holds that appraiser is liable to home buyer when appraiser is negligent in preparing appraisal that appraiser delivers to lender. ***Sage v. Blagg Appraisal Co. Ltd., 221 Ariz. 33, 209 P.3d 169 (2009).***

This case contains a number of facts that may distinguish it from the more Atypical" lender/appraiser situation, but before anyone dances around the room in relief, the editor recommends studying the complete holding, which appears to reach much broader than these somewhat narrow facts.

Sage made a written offer to purchase a home for $605,200. The broker's form contract that she used provided that the buyer's obligation to complete the purchase was "contingent upon an appraisal of the Premises by an appraiser acceptable to the lender for at least the sales price." (The editor has not seen such language in any form agreements he has seen in his neighborhood.) The contract provided that Sage would reimburse the cost of the appraisal.

On the advice of her real estate agent, Sage asked the lender, Security, to retain Blagg to perform the appraisal. In performing the appraisal, Blagg spoke to Security, but not to Sage, and submitted the appraisal only to Security. But Sage had signed a request for the appraisal, and she did receive it. The appraisal set the value of the home at $620,000, and Sage bought the home.

Eighteen months later, Sage sought to refinance the home and obtained another appraisal. This appraiser fixed the size of the home at over 500 feet less than Blagg had set forth in his appraisal, a shortfall of around 20percent. At the time of the refinancing, this being the "hot times," the home, even in reduced size, was appraised at $700,000. Nonetheless, Sage sued Blagg, alleging that she would not have purchased the home had she known its true size and value at the time of her purchase. Sage alleged that at the time she purchased, the home would have been worth only about $350,000.

The trial court followed a "straight Restatement" approach, evaluating whether the case fits with

Restatement Section 552, relating to the duty of professionals to third parties relying upon their work. Liability claims under the section are limited (in relevant part) to losses suffered [in relevant part]:

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it;

(b) through reliance upon it in a transactions that he intends the information to influence or knows that the recipient so intends.

Citing these provisions, and a wide array of prior cases around the country denying appraisal liability in similar situations, the trial court granted summary judgment to the appraiser.

The trial court noted that it was clear to Sage that the purpose of the appraisal was to satisfy the lender, and that the expectation was that the appraisal meet the lender's requirements. The court noted that the appraisal itself recited that it was given only to the "lender/client" for a mortgage finance transaction and that it could not be used for any other purpose.

The Court of Appeals reversed:

The court first agreed that Blagg did not deliver the appraisal report to Sage and did not intend that the lender so deliver it. So liability did not lie under subsection 552(a) of the Restatement. But the court did indicate that Blagg knew or should have known that Sage had the right to request a copy of the appraisal report and did have a copy of the contract that made the sale "contingent on appraisal."

But the court then elected to go beyond the restrictions of the Restatement, citing a number of recent cases in which the courts held that the appraiser's knowledge of the overall significance of the appraisal in the purchase process – as the key information upon which the lender basis its decision on the amount of the loan – placed the buyer within the group of target beneficiaries of the appraiser's work.

"We reject Blagg's argument that an appraiser owes no duty to the buyer/borrower pursuant to Restatement 522 because the loan transaction by which the buyer/borrower acquires the funds to purchase the home is distinct from the purchase transaction . . . the appraisal the lender orders typically is the foundation of the home purchase transaction. Although Blagg argues that, as the appraiser, he served only the mortgage/lending transaction and not the separate transaction by which Sage purchaser her home, we believe that distinction is without difference. "lender it Security's position will not finance the buyer's purchase if it appraiser concludes the home is not worth the financed amount."

The court went on to emphasize that this particular contract gave the buyer an "out" if the appraisal fell short. But the editor believes that the above language goes beyond cases involving that feature and applies to ordinary contracts where the sole contingency is loan approval.

It notes:

> "A buyer in Sages's position necessarily learns from the lender at least the bare fact of whether the appraiser estimated value met the lender's value requirement. If the appraiser's estimate falls short, the loan will not be made while, if the loan is made the buyer learns at least by inference that the home has appraised at least the required amount.

As the editor reads the opinion, this transfer of information about the appraiser's conclusion renders the appraiser liable for negligence in the preparation of that conclusion.

Comment 1: The opinion cites a number of other recent cases discussing these issues, and it is therefore difficult to say that there is anything here that is unprecedented or "cutting edge." But it certainly represents a trend expanding the scope of appraisal duty to home purchasers. Will this lead to other extensions? Stay tuned.

Comment 2: Note that, based upon the alleged facts, the negligence in the appraisal appears to be pretty obvious. But there will be many more cases in which negligence will be far more difficult to prove. Unfortunately for appraisers, the fact of negligence typically is a question of law that survives summary judgment and leads the appraiser to a choice of settlement or trial.

BILLBOARDS; EMINENT DOMAIN; DAMAGES; ADVERTISING REVENUES: When making the determination of adequate compensation after the state

condemns an easement used for billboard advertisements, expert testimony assessing the market value of the easement should not include the advertising revenues generated from the use of the easement. ***Texas v. Central Expressway Sign Assoc., ___ S.W.3d _, 2009 Westlaw 1817305 (Tex. 2009)***, discussed under the heading: "Eminent Domain; Damages; Billboards; Advertising Revenues."

BROKERS; LEASING BROKERS COMMISSIONS: Where a right of first refusal in a lease does not guarantee the landlord-seller a particular net recovery and does not require a tenant to pay the brokers' commission, a tenant is only required to match the gross sales price in the third-party offer and the landlord is obligated to pay whatever brokerage commissions are set out in the lease ***St. George's Dragons, L.P. v. Newport Real Estate Group, L.L.C., 407 N.J. Super. 464, 971 A.2d 1087 (App. Div. 2009)****;* June 3, 2009, discussed under the heading: "Landlord/Tenant; Purchase Options; Rights of Refusal."

CONTRACT LAW; PERFORMANCE; IMPOSSIBILITY OF PERFORMANCE; IMPRACTICABILITY: Under the contractual doctrine of temporary commercial impracticability, impracticability of performance or frustration of purpose that is only temporary suspends an obligor's duty to perform for the duration of the impracticability or frustration; it does not discharge the ultimate duty or prevent it from arising. Thus, temporary impracticability only relieves the promissor of an obligation to perform for as long as the impracticability lasts plus a reasonable time afterwards. ***Hoosier Energy Rural Electric Cooperative, Inc., v. John Hancock Life Insurance Company,*** **588 F. Supp. 2d 919 (S.D. Ind. 2008).**

This case provides a case study of some of the worst aspects of modern finance. The case arises from an elaborate transaction that combines the sometimes toxic intricacies of credit default swaps and investment derivatives with a blatantly abusive tax shelter. Investment bankers and lawyers made more than $12 million in fees for putting together the paper transaction known as a "sale in – lease out" or "SILO" transaction of an electrical generating plant. Although all parties have been making all payments required under the contracts, the transaction is now in crisis because credit rating agencies have downgraded the credit ratings of one of the parties.

At this stage of the case, plaintiff Hoosier Energy Rural Electric Cooperative, Inc. seeks a preliminary injunction to enjoin defendants (i) John Hancock Life Insurance Company, Merom Generation I, LLC, and OP Merom Generation I, LLC (collectively, "John Hancock"); and (ii) Ambac Assurance Corporation and Ambac Credit [**3] Products, LLC (collectively, "Ambac") from making any demand or any payment pursuant to any assertion that a default has occurred and enjoining John Hancock from asserting that a default has occurred.

Plaintiff Hoosier Energy owns and operates an electrical generating plant in Merom, Indiana on the Wabash River. In 2002, Hoosier Energy and the other parties entered into a complex transaction known as a "sale in – lease out" or "SILO" in which Hoosier Energy leased certain assets at its Merom power plant to John Hancock for a term of 63 years (longer than its useful life) and then leased the same assets back for a term of 30 years. John Hancock made an immediate one-time payment of $300 million for its 63 year lease. John Hancock then immediately leased these assets back to Hoosier Energy. Hoosier Energy kept about $20 million, and approximately $278 million was deposited with various Ambac entities, which in turn were required to make lease payments on Hoosier Energy's behalf to John Hancock. Hoosier Energy made payments into other funds controlled by Ambac with an eye toward the back end of the deal, when it would be virtually certain that Hoosier Energy would remain in control of the Merom plant.

The transaction was promoted and designed by lawyers and investment bankers (transaction costs were more than $12 million) with the hope that it would allow John Hancock to claim to be the "owner" of the Merom plant for tax purposes and thus enable it to claim tens of millions of dollars of tax deductions. Those deductions were of no use to Hoosier Energy as the plant owner because it simply does not earn significant profits. It is a cooperative made up of members that are rural electric cooperatives.

As part of the complex transaction (documented in approximately 4,000 pages of fine print), Hoosier Energy was required to obtain a "credit default swap" from Ambac to give John Hancock further assurance that it would actually receive the promised lease payments. In general terms, the parties agreed that if Hoosier Energy defaulted on its obligations under the contracts,

John Hancock could demand a "termination payment" from Ambac, and Ambac could turn to Hoosier Energy for payment under a closely parallel credit default swap contract between Ambac and Hoosier Energy. Ambac also provided a surety bond for the benefit of John Hancock.

As part of the terms of this credit protection for John Hancock, the parties agreed that if Ambac's credit rating dropped below a specific threshold, Hoosier Energy would have sixty days to find a new qualified swap provider. Hoosier Energy's failure to secure a new qualified swap provider would allow John Hancock to declare a default under the contracts, to terminate the entire transaction, and to demand an early termination payment from Ambac. In that event, Ambac would be able to demand very substantial payments from Hoosier Energy. The parties agreed to a schedule for the termination payment, depending on the date of the payment. The schedule was designed to give John Hancock, in the event of termination, the "Net Economic Return" it hoped to receive from the entire transaction, based on the assumption that it would be entitled to all of the hoped-for tax benefits.

Around the time these parties closed the Merom SILO transaction in 2002, the IRS began disallowing claimed income tax deductions from taxpayers who had participated in other SILOs. Courts have decided in favor of the IRS on transactions structured similarly to the Merom SILO transaction among these parties. *See, e.g.*, *BB&T Corp. v. United States*, 523 F.3d 461, 477 (4th Cir. 2008) ("LILO" or lease in-lease out); *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953, 2008 U.S. Dist. LEXIS 42761, 2008 WL 2230744 (N.D. Ohio May 28, 2008) (SILO). The IRS had gone so far as to offer a form of tax amnesty for parties to similar SILO and LILO transactions, which the IRS deemed abusive tax shelters. The IRS announced that taxpayers involved in more than 80 percent of the SILO and LILO transactions had accepted the offer. John Hancock apparently chose not to take advantage of this offer, at least with respect to the Merom SILO transaction.

Notwithstanding the tax problems, the IRS apparently had not yet examined the Merom deal or challenged John Hancock's claimed tax deductions that appear to have been in the tens of millions of dollars so far. All parties to the transaction made all payments required under the contracts.

In June 2008, however, Ambac's published credit rating fell below the level specified in the contract documents. Hoosier Energy was notified of this change, recognized that the contract required it to find a new participant with comparably strong credit ratings, and began looking. It encountered extraordinary difficulty in doing so. As the court stated, the 2008 credit "tsunami" appeared to be the primary reason that Ambac's credit rating fell. The credit crisis also appears to have made it impossible – or nearly impossible – for Hoosier Energy to find a substitute for Ambac with a sufficient rating, on time, and at any price.

In December 2007, nine of the thirteen financial guarantors tracked by Moody's and Standard & Poor had ratings that satisfied the criteria of the Merom SILO agreements. In the summer and fall of 2008, credit markets experienced unparalleled adverse events. By June 2008, only three of those thirteen guarantors had the requisite ratings. The crisis was not anticipated by the most senior economists in the country.

On June 19, 2008, Moody's downgraded Ambac to a rating of Aa3, which gave Hoosier Energy sixty days to replace Ambac in the credit default swap arrangements. Hoosier Energy immediately began trying to replace Ambac with a credit enhancement vehicle that would meet the credit conditions of the Merom SILO agreements.

Hoosier Energy informed John Hancock of these efforts by letter on June 20, 2008 but warned that it could take more than sixty days to secure a replacement because of the extraordinary state of the credit markets. Hoosier Energy also proposed potential solutions to the situation, including allowing Hoosier Energy more than the sixty days contemplated in the Agreement to secure a replacement, granting waiver of the Aa2 credit rating requirement, restructuring the transaction without credit enhancement requirements, and unwinding the transaction altogether. Hoosier Energy, John Hancock, Ambac, and CoBank conferred on July 10th, and John Hancock appeared to support Hoosier Energy's efforts in the face of the credit crisis. However, on July 21st, John Hancock rejected the proposals Hoosier Energy outlined in its June 20th letter, including permitting Hoosier Energy additional time to find a replacement for Ambac.

Hoosier Energy's efforts continued, and by August 6th it had made progress in negotiating with Bank of America and CoBank for letters of credit in amounts equal to the

equity portion of the termination value. Hoosier Energy informed John Hancock of this development. John Hancock responded positively, stating that it would accept the proposed letters of credit but that it preferred to have Bank of America support the entire amount. John Hancock also stated that it would extend the replacement period until September 2nd, contingent on production of either signed term sheets or letters of intent from Bank of America and CoBank. However, Bank of America decided not to proceed with the credit enhancement for the Merom SILO transaction.

On October 3rd, John Hancock agreed to extend the replacement period, but only by twenty days. Hoosier Energy attempted to accelerate the finalization of a new deal with Berkshire Hathaway. On October 13th, its board of directors voted to approve the term sheet, and the Berkshire Hathaway term sheet was executed. Hoosier Energy forwarded a copy of the executed term sheet to John Hancock. The replacement period was due to expire on October 22nd, and Hoosier Energy sent a draft Third Waiver Extension Agreement to John Hancock that would extend the replacement period by another 90 days. John Hancock did not respond. Also on October 22nd, Hoosier Energy was reassured that although Berkshire Hathaway senior management needed to approve the deal, Berkshire intended to close the deal. Hoosier Energy informed John Hancock of Berkshire's intent.

On October 23rd, however, the same day that Alan Greenspan testified about the "credit tsunami," John Hancock pulled the plug on Hoosier Energy's effort to replace Ambac. John Hancock rejected Hoosier Energy's request for an additional extension and informed Hoosier Energy that an "Event of Default" had occurred under the contract. John Hancock advised Ambac that it would expect its termination payment of approximately $120 million on October 31, 2008. Such a payment would immediately trigger a duty on the part of Hoosier Energy to pay Ambac either the same sum of approximately $120 million immediately, or at least $26 million immediately, followed by installment payments over four years for total payments of approximately $160 million. Ambac stated that it was ready, willing and able to make the $120 million termination payment to John Hancock unless it enjoined from doing so.

Hoosier Energy did not argue that the credit crisis should forever excuse its obligation to replace Ambac as a credit swap partner. Hoosier Energy argued that, given the extraordinary but temporary circumstances presented by the credit crisis, it was entitled to a reasonable period of additional time to replace Ambac under the doctrine of temporary commercial impracticability.

The court cited the commentary of an earlier case supporting the Acommercial impracticability defense" and stating its basic principles:

> "In the overwhelming majority of circumstances, contractual promises are to be performed, not avoided: pacta sunt servanda, or, as the Seventh Circuit loosely translated it, 'a deal's a deal. . . .' Even so, courts have recognized, in an evolving line of cases from the common law down to the present, that there are limited instances in which unexpectedly and radically changed conditions render the judicial enforcement of certain promises of little or no utility. This has come to be known, for our purposes, as the doctrines of impossibility and impracticability. Given the importance of the principle that courts respect and enforce parties' valid and lawful contracts, these are doctrines that must be employed with great caution, but they retain a place in the law under sufficiently extreme circumstances."

To assert the affirmative defense of commercial impracticability, "the party must show that the unforeseen event upon which excuse is predicated is due to factors beyond the party's control." Temporary commercial impracticability excuses performance until circumstances have changed, plus a reasonable time afterwards:

Impracticability of performance or frustration of purpose that is only temporary suspends the obligor's duty to perform for the duration of the impracticability or frustration; it does not discharge the ultimate duty or prevent it from arising. Thus, temporary impracticability only relieves the promisor of an obligation to perform for as long as the impracticability lasts plus a reasonable time.

John Hancock countered that an economic crisis cannot support a defense of impracticability, and that if that argument prevailed, "every debtor in a country suffering economic distress could avoid its debts." John Hancock also relied heavily on *Kel Kim Corp. v. Central Markets,*

Inc., 70 N.Y.2d 900, 519 N.E.2d 295, 524 N.Y.S.2d 384 (N.Y. 1987), in which the court refused to excuse a tenant's failure to provide liability insurance when, due to a liability insurance crisis, the tenant was unable to secure the level of insurance required by the lease. The court found that the tenant's "inability to procure and maintain requisite coverage could have been foreseen and guarded against when it specifically undertook that obligation in the lease. . . ." John Hancock argued that it was not actually impossible for Hoosier Energy to find a replacement for Ambac, and that in any event, Hoosier Energy should have foreseen and guarded against its inability to find a replacement.

The instant court concluded that if the nature and scope of the credit crisis were more limited or a "mere economic downturn," John Hancock's argument that the crisis was foreseeable or that Hoosier Energy should have protected itself better might be more persuasive. However, court noted, the credit crisis facing the world's economies in recent months is unprecedented and was not foretold by the world's preeminent economic experts. The crisis certainly was not anticipated in 2002, when the deal between Hoosier Energy, Ambac, and John Hancock was being finalized. ARetrospect will not assist John Hancock here, nor will an assertion that it was Hoosier Energy's responsibility to prepare for and guard against any imaginable commercial calamity. [the court quoted John E. Murray, Jr., Murray on Contracts 112 at 641 (3d ed. 1990) ("If 'foreseeable' is equated with 'conceivable', nothing is unforeseeable."]. Hoosier Energy , the court concluded, had come forward with evidence indicating that the obstacles it faced were not specific to Ambac but were the product of the credit crisis that effectively but temporarily froze the market for comparable credit products at any price. Those effects were not anticipated and could not have been guarded against.

John Hancock pointed out that Hoosier Energy had been reluctant to accept terms offered by Berkshire Hathaway because the deal would have been, in Bernardi's words, "prohibitively expensive." Expensive does not mean impossible or impracticable. But the evidence shows that on October 13th, Hoosier Energy signed the term sheet for those "prohibitively expensive" terms, forwarded that information to John Hancock, and asked for time to close the deal. Thus, Hoosier Energy's temporary commercial impracticability argument seems to depend on the logistics of closing another complex deal, not on the expense of that deal.

Unlike the defendants in other cases that had denied the defense of commercial impractibility, Hoosier Energy did not ask John Hancock to excuse its performance for an uncertain or unlimited period of time. In the midst of unprecedented economic tumult, Hoosier Energy had made significant headway in securing Ambac's replacement, even at what Hoosier Energy described as a prohibitive price. But even after credit markets began to thaw, Hoosier Energy needed an additional ninety days to finalize the $120 million deal with Berkshire Hathaway, a deal that was already on the table. John Hancock pointed out that Hoosier Energy, by contract and with agreed extensions, had already had more than 120 days to replace Ambac. John Hancock contended that it was not obligated to grant Hoosier Energy unlimited extensions. Unlimited extensions, no. But reasonable extensions, in a time of economic crisis and under the doctrine of temporary commercial impracticability, yes. The Berkshire Hathaway deal, before John Hancock turned out the lights, was not theoretical or speculative. The preliminary terms had been executed and Berkshire Hathaway had indicated its intent to proceed. Under any circumstances, ninety days does not seem an unreasonable amount of time to finalize a complicated $120 million deal. Given the state of economic affairs on October 23rd, when John Hancock refused the extension, ninety days appears to have been a reasonable request. The court held that Hoosier had shown a reasonable likelihood of success on the merits on its defense of temporary commercial impracticability.

John Hancock pointed out correctly that if the court granted injunctive relief, it would be exposed to credit risks greater than those it agreed to accept. That exposure reflected potential harm to John Hancock, but that potential harm paled next to the virtual certainty of the serious irreparable harm that an erroneous denial of injunctive relief would have inflicted on Hoosier Energy and its constituent REMCs. In addition, even in the unlikely scenario in which Ambac would be unable to satisfy its obligations, John Hancock had an over-collaterized mortgage and security interest in the Merom plant. That security is less liquid than the credit default swap with Ambac, but it nevertheless provided substantial security.

The character of the Merom SILO transaction as an abusive tax shelter also factored into the court's weighing of the equities. John Hancock understandably pointed out

that Hoosier Energy happily entered into the transaction and received some $20 million in cash at the front end, and had not complained about the tax aspects of the transaction until now. John Hancock argued that the court should not interfere with Ambac's payment on its credit default swap with John Hancock and should defer consideration of Hoosier Energy's defenses to a later lawsuit between Ambac and Hoosier Energy. That approach would probably have resulted in a great inequity if Hoosier Energy's challenge to the legality of the transaction were sound. John Hancock would walk away with the economic equivalent of the tax windfall it hoped to gain. Ambac would be left unable to collect from Hoosier Energy on the theory that the obligations of this entire transactions are void and that the courts should leave the parties where they find themselves. Yet John Hancock is the party who, in effect, tried to buy tax deductions it was not entitled to and who knowingly accepted the risk that the transaction might be deemed a sham and an abusive tax shelter.

The court considered whether it should simply deny all relief on a theory of "unclean hands." After all, Hoosier Energy was itself a party to the transaction it claimed to be a sham. If the court reached a final decision that the transaction was a sham, the court would face some challenging problems in crafting any appropriate remedies. But the court concluded that the more prudent, risk-minimizing course at this point is to grant injunctive relief to prevent irreparable harm and to sort out later the difficult terms of final equitable relief (such as addressing Hoosier Energy's $20 million in up-front benefits from the transaction).

Consequently, the court granted the requested injunctive relief.

CONSTRUCTION LAW; INSURANCE; WAIVERS OF SUBROGATION: Construction contract provision that there would be waiver of subrogation to extent of "other insurance applicable to the Work," did not extend the period of waiver to periods following construction even when the owner had obtained insurance. Insurer not barred from subrogation claim. ***Hartford Underwriters Insurance Company v. Phoebus, 2009 WESTLAW 271327, (Md. Ct. Spec. App. 8/31/09)*** **(not yet released for publication)** discussed under the heading: "Insurance; Fire Insurance; Subrogation; Waivers; Construction Completion Clause".

EASEMENTS CREATION; PRESCRIPTION: Prescriptive claimants who lived a half- mile from claimed servient property owners had a prescriptive easement to beach over owners' property. ***Denardo v. Stanton, 906 N.E.2d 1024 (Mass.App.Ct. 2009).***

Plaintiffs owned property along Beach Way, a private way that ran within a residential subdivision and provided access to the beach. Defendants owned property approximately one-half mile from Plaintiffs' property, in an adjacent subdivision.

For more than 20 years, Defendants and their predecessors crossed from their property, along a narrow dirt road located partly within their subdivision, onto Beach Way to gain access to the beach. For a time, Plaintiffs or their predecessors had placed boulders on Beach Way to par vehicular access, but pedestrian traffic had apparently continued.

In 2004, Plaintiffs filed an action in Land Court, seeking an order declaring that Defendants had no right, title, or interest in Beach Way, and to preclude them from using Beach Way to gain access to the beach. Defendants claimed that they obtained a legal right to use Beach Way due to an established prescriptive easement.

The trial court held that Defendants held a prescriptive easement to travel by foot over Beach Way. Plaintiffs appealed.

The Appeals Court first considered Plaintiffs' claim that Defendants' use of Beach Way was not appurtenant to their land because of the half-mile distance between the two properties. Plaintiffs claimed that although Massachusetts law does not require that the dominant and servient estate be adjacent, there must be an obvious connection between the two estates such that the benefit of the easement must be apparent to the servient estate's owner.

The Court rejected this contention as going beyond the applicable standard. Massachusetts law provides that an easement is appurtenant when it is "created to benefit and does benefit the possessor of land in his use of the land." There is no requirement that a connection between the estate be apparent to the servient owner. Such a requirement would conflict not only with the objective nature of the open and notorious use requirement, but also with the historically applied presumption in favor of appurtenant easements.

Therefore, the Court upheld the land court judge's finding that the use of Beach Way was closely tied to the use and enjoyment of Defendants' properties, and therefore was appurtenant to their properties.

Second, the Appeals Court rejected Plaintiffs' claim that Defendants did not satisfy the elements of a prescriptive easement. The Court found that Defendants' demonstrated use of Beach way that was open, notorious, adverse, and continuous for a period of twenty years. There was ample evidence to demonstrate that Defendants' and their predecessors in title used Beach Way adversely for a period exceeding the twenty year requirement, in a manner consistent with the type of property owned, namely a beach house that was primarily used on the weekends.

Because evidence demonstrated that Plaintiffs' placed boulders across Beach Way for a period of time, thereby preventing vehicular access, the Land Court judge property determined that Defendants' established only a prescriptive easement for travel by foot.

Comment 1: As a property law teacher, the editor has labored annually to drive home to students the concept that "appurtenant" in the context of easements does not necessarily mean "adjacent." Unfortunately, there is some judicial language, and perhaps some language in popular student outlines, to suggest otherwise.

But the concept is nevertheless clear. If a landowner benefits in the use of his land by having the right to physical access to the land of another, the easement can be appurtenant and the burden and benefit can pass with transfer, and the benefit is limited to the benefitted parcel. This isn't going to happen every time. Often, when the benefitted party has property some distance from the burdened property, the easement will be deemed to be in gross. But nothing says it has to be.

Comment 2: Another interesting feature of the case is the use of the rocks to block the road. Although this clearly demonstrated hostility on the part of the servient owners, and perhaps would be relevant in a "lost grant" jurisdiction (a distinct minority), the degree of interruption to terminate a prescriptive use in most jurisdictions must be a blockage of access. Apparently people just walked around the rocks.

EASEMENTS; ABANDONMENT; RAILROADS: Even where original deed to railroad purports to convey Aa strip of land . . . forever," such deed is not a grant of fee simple to the railroad, but only an easement, when the deed is further qualified by expressions of purpose that the strip of land is to be used for a right of way for railroad purposes. ***Timberlake, Inc. v. O'Brien, 902 N.E.2d 843, (Ind.App. 2009).***

In 1973, Timberlake purchased 40 acres of land in LaPorte County, Indiana pursuant to a warranty deed. There was a strip of land adjacent to Timberlake's property that was originally conveyed to the predecessor railroad company of CSX in 1881 pursuant to three deeds. Each handwritten instrument stated that "a strip of land" was conveyed "forever" but further stated that the conveyance was for railroad purposes and in some detail permitted the railroad company to construct, maintain, and use a railroad over the strip of land in each parcel.

On July 31, 1988 CSX filed a notice with the Interstate Commerce Commission indicating its intent to abandon the railroad running over Timberlake's property. On June 28, 1990, before it had removed its rails, ties, and ballast, CSX conveyed its interest in the property to O'Brien.

In 1991, CSX removed its rails, ties and ballast. On June 29, 2004, Timberlake brought suit in LaPorte Circuit Court to quiet title to the railroad property and for trespass, to declare that Timberlake was entitled to an easement by necessity, and to enjoin O'Brien from blocking access to the property. On December 1, 2005, Timberlake filed a motion for summary judgment on its claim to quiet title to the railroad property. In its motion, Timberlake asserted that CSX only held a railroad easement to the property and by abandoning the property prior to executing the quitclaim deed with O'Brien, CSX extinguished the right-of-way easement. Timberlake maintained that as a result, O'Brien had no claim to the property.

O'Brien, who operated a golf course and other operations adjacent to the strip, argued that the original conveyance to the railroad's predecessor was in fee.

On January 2, 2008, the trial court denied Timberlake's and O'Brien's motions for summary judgment. The trial court concluded that the 1881 deeds instituted right-of-way easements for use by a railroad and could not be characterized as transfers in fee. The trial court further held that because CSX had not yet removed its track and

ballast from the property at the time of conveyance to O'Brien, the property was not abandoned and therefore O'Brien received a railroad right-of-way interest.

Timberlake appealed, and the appeals court affirmed. This was a relatively straightforward matter because the state legislature had passed a statute holding that an easement was not deemed abandoned until the Interstate Commerce Commission had approved the abandonment and the rails had been removed. Apparently prior decisions had challenged [properly] the constitutionality of the statute, and it had been amended. The court apparently accepted the amended version here and concluded that it was binding on the issue of abandonment.

But the court went on to moot its above holding when it held that O'Brien's sole interest in the right of way was for railroad purposes. The court noted Indiana authority that held that although a grant of a "strip of land" in Indiana to a railroad will be viewed as a grant in fee, qualifications of the grant stating that it is to be used as a right of way for railroad purposes turns the grant into an easement, notwithstanding that the grant is made "forever."

Comment 1: Because of the peculiarities of the statute, it appears that O'Brien continues to hold a railroad easement in the property notwithstanding the fact that the rails and tracks have been removed, unless and until CSX's petition to abandon is approved by the ICC. Bizarre, particularly when a prior class action had attempted to resolve abandonment issues in favor of neighbors.

Comment 2: The issue of existence and abandonment of railroad rights of way continues to be a matter of great significance in rural America. The court doesn't answer all the questions. The court does state that an unqualified grant of a "strip of land" to a railroad will be viewed as a grant in fee, and that where the grant is qualified by a statement that it is for railroad purposes, it will be an easement. But the court emphasizes the language "right of way" as part of the qualification. Here the term "right of way" appeared in the deeds in question. Without that language, this case doesn't really stand as a holding for the proposition that other qualifying language that expresses the railroad intent is sufficient to make the deed into an easement.

EASEMENTS; MODIFICATION: Nevada approves Restatement rule permitting unilateral modifications in some cases, but applies Restatement limitation that easements with expressly described boundaries cannot be modified. ***St. James Village, Inc. v. Cunningham, 210 P.3d 190 (Nev. 2009).***

Four individuals (the "Cunninghams") owned two parcels of land immediately adjacent to a 1,600 acre tract of property owned by St. James Village. The predecessor in title to the Cunninghams' lots purchased an access easement across the 1,600 acre tract from St. James Village's predecessor in title. The easement served one purpose: it afforded access to a public road from the two lots. The location of the easement was explicitly described in a metes and bounds legal description; the easement was silent as to the ability of the servient estate to relocate the easement.

St. James Village purchased the 1,600 acre tract with the intention of building "a master-planned, gated community." The easements, if not relocated, crossed 14 lots in the subdivision. Two of the lots the easement crossed were approved and recorded, and the other twelve merely approved. St. James' planners realized that shifting the easement's location would allow the Cunnighams to reach the public road and merge the easement into the subdivision roads in St. James Village. (The opinion states that the proposed alteration included "adding curves" to align the easement with roads planned by the developer.)

As you might guess, St. James Village approached the Cunninghams and offered to negotiate (and presumably pay) for a relocation of the easement. The opinion does not relate the terms of the offer made by St. James Village, but we do know the offer was rebuffed.

St. James Village then brought an action for declaratory relief asking the court to approve a relocation of the easement, arguing that relocation would not "materially inconvenience" the Cunninghams. The trial court held for Cunninghams, relying on *Swenson v. Strout Realty, Inc.*, 452 P.2d 972 (Nev. 1969), which the trial court argued was controlling Nevada law. According to the trial court, permission of the owner of the dominant estate is always required to a relocation of an easement. The Nevada Supreme Court affirmed the trial court, but did so on other grounds. The Nevada Supreme Court adopted the reasoning of §4.8 of the Restatement (Third) of Property (Servitudes). However, the Nevada Supreme Court held that the plain meaning application of the Restatement

would require St. James Village to obtain the consent of the Cunninghams, for reasons set out below.

§4.8 of the Restatement (Third) of Property provides: "Except where the location and dimensions are determined by the instrument or circumstances surrounding creation of a servitude, they are determined as follows:

> (1) The owner of the servient estate has the right within a reasonable time to specify a location that is reasonably suited to carry out the purpose of the servitude.
>
> (2) The dimensions are those reasonably necessary for enjoyment of the servitude.

Because the Plaintiff has failed to plead a cognizable claim under Nevada law, the Court finds that Defendants have met the standard of dismissal by showing that Plaintiff is not entitled to relief under any set of facts that could be proved in support of its claim.

The court noted that, unless expressly denied by the terms of an easement, as defined in § 1.2, the owner of the servient estate is entitled to make reasonable changes in the location or dimensions of an easement, at the servient owner's expense, to permit normal use or development of the servient estate, but only if the changes do not:

> "(a) significantly lessen the utility of the easement,
>
> (b) increase the burdens on the owner of the easement in its use and enjoyment, or
>
> (c) frustrate the purpose for which the easement was created."

The Nevada Supreme Court in St. James Village first evaluated Swenson, its prior statement on the subject of relocation of easements. In Swenson, the court stated "the location of an easement once selected cannot be changed by either the landowner or the easement owner without the other's consent." The court in St. James Village noted that this statement might have been *dictum*.

Swenson involved a real estate broker's suit to recover a commission; the sellers counter sued that they did not owe commission because of the broker's misrepresentation in a separate transaction in which the broker stated that an easement could be relocated. The court held that the broker's statement of law was false. Because the Swenson court evaluated the substance of the broker's claim that the easement could be relocated, the St. James Village court considered the Swenson court's statement of law that an easement may not be relocated without consent of the easement holder authoritative analysis. The court in St. James Village therefore took the issue of the right to relocate an easement head on.

The St. James Village court adopted the Restatement approach. It acknowledged that this newer approach might lead to additional litigation: owners of servient estates will use the new rule to relocate easements over the objections of the easement owner, and the parties will litigate what is "reasonable" under the circumstances, and what will unduly burden the easement's owners use and enjoyment of the easement. However, the St. James Village court suggested that this concern is outweighed by the social utility of the new rule. According to the court, easements will cost less under the new rule because it will be possible for servient tract owners to relocate them. This in turn will lead to a greater use of easements generally.

By contrast, the older rule that requires the consent of the easement holder creates a rigid right that the easement holder will only sell for more than its real value. In St. James Village, for instance, St. James Village did not want to terminate the easement or add significant travel time on the access rights of the easement holder. According to the facts (as presented in the opinion), St. James Village just wanted to "add some curves" to the access way to allow the easement to run along the road rather than across actual lots. The easement owners – the Cunninghams – arguably were not harmed by the relocation of the easement. The Cunninghams likely would have been willing to travel the extra way (along curves rather than a straight line) if their price had been met.

The Cunninghams responded, as have most holders of easements facing this new Restatement rule, by pointing out that they bargained under the older rule. In other words, they or their predecessors paid too much money for the easement. The court recognized the validity of this argument, but said, simply, "after balancing public policy considerations, we adopt the Restatement rule."

To bolster its sense of comfort, the St. James Village court noted that other jurisdictions have been swinging in this direction. The court cited Massachusetts (*M.P.M. Builders, LLC. v. Dwyer,* 809 N.E. 2d 1053 (Mass. 2004)) and Colorado (*Roaring Fork Club, L.P. v. St. Jude's Co.*, 36 P. 3d 1229 (Colo. 2001)).

St. James Village ultimately lost, however. The easement in question was described precisely by a metes and bounds legal description. According to the court, this indicated that the purchaser of the easement – Cunninghams predecessor in title – relied on the exact location of the easement. The court argued that the Restatement enforces the easement holder's veto power if the easement is precisely described. According to the court:

"The language prefacing section 4.8 unambiguously states that the rule's provisions apply "[e]xcept where the location and dimensions are determined by the instrument or circumstances surrounding creation of a servitude." Interpreting this introductory language as meaning that section 4.8's provisions will govern the relocation of easements so long as the easement at issue does not have a location or dimensions certain is consistent with subsection 3. Subsection 3 does not have any bearing on the introductory language of the rule; rather, subsection 3 is another limitation. Under section 4.8(3), even if the easement does not have a location or dimensions certain, if the creating instrument prohibits relocation, then the servient estate owner may not avail himself or herself of the Restatement rule's unilateral relocation provision."

Reporter's Comment 1: This case marks one more victory in the continuing successful transformation in easement law resulting from the ALI's servitude project. Some aspects of the various Restatement projects are adopted slowly or seem never to catch on. Not so in the case of easements. This is a boon to developers of residential and commercial property in communities where unimproved land is scarce or land is subject to long standing easement rights.

Reporter's Comment 2: The changes wrought by the Restatement on the law of servitudes and easements have been the subject of tremendous debate and scholarship. But as a practical matter, the reporter wonders if the prefatory language to §4.8 will not become the exception that swallows the rule. Many easements, including easements that later become quite useless, are described precisely in creating documents by metes and bounds descriptions. What good will the Restatement do if these cannot be altered?

Reporter's Comment 3: But didn't the developer see the easement location before buying the property with the intent to subdivide? The easement was recorded. If so, wouldn't the existence of the easement have been factored into the price the developer paid for the property? The opinion states that after buying the property subject to the easement, and presumably knowing about the easement, St. James Village designed its master gated community – streets, lots, sidewalks, etc. It did so with knowledge of the location of the easement. The developer buys the property for a value reflecting the encumbrance, then has the encumbrance removed without paying the easement holder. (Of course, it "paid" in terms of legal fees.)

Editor's Comment 1: The Editor fears that the Reporter has surrendered the field too quickly to the Restatement here. Many courts are loathe to alter existing property rules because some professor thinks there is a better idea. Indeed, until now, the score among states considering whether to adopt the Restatement's changes still favors the status quo. Washington (*MacMeekin v. Low Income Hous. Inst., Inc.*, 45 P.3d 570 (Wash. App. 2000) (the DIRT DD for 5/3/02)); and Georgia, *(Herren v. Pettengill*, 538 S.E. 2d 735 (Ga. 2000) have rejected the Restatement rule, and the editor believes that the same is true of North Carolina. Other states, including New York and South Carolina, permit modification only of prescriptive or implied easements. And New Jersey also has weighed in against the general rule of modification. See Editor's Comment 3 below.

Editor's Comment 2: The court's notion that there will be more and cheaper easements if the easement grantor believes that the easement can later be relocated is absurd. Presumably the easement grantee will also be aware of the possibility that some judge at some time may decide that the easement rights the grantee purchased may be moved, and in fact the easement does not have the permanence that earlier was the case. The grantee may therefore insist on non-modification or may offer a price so low that the deal collapses, leading the proposed grantee to solve the problem some other way.

The fact is that this is not a situation where the existing law does not track the expectations of the parties. Most people in the field, if they think about it, will conclude that an easement is permanent. And, if this is a matter of concern to the grantor, the grantor will bargain for language that will change that circumstance. The Restatement, in short, does not assist the parties in creating bargains for easements, and may in fact frustrate parties in their later expectations. As the court says, this likely will lead to litigation.

Are easement rights abused? Are they asserted to block development where the easement holder has no benefit at all? Yes, of course. But courts always have the power under existing law to deny specific performance of an easement right and leave the benefitted party to an action in damages. *Bubis v. Kassin*, 353 N.J. Super. 415, 803 A.2d 146 (App. Div. 2002) (the DIRT DD for 2/25/03), which refuses to permit judicial modification of easements, but notes that courts can, in the appropriate case, deny injunctive relief to prevent interference with an easement on a temporary basis, reserving the right to restore the easement to its place at another time. This approach is rarely used because, in fact, most easement owners do in fact have a viable and useful property right which they purchased and value.

Editor's Comment 3: Is it enough to limit modification rights to easements that are not described exactly by the parties or where modification is prohibited? This assumes as noted above, that the parties understand that one of these steps are necessary. In fact, as the Restatement is proposed for application even to existing easements, there is no way the parties to those deals could have anticipated these steps were necessary. The same, in fact, will be true for many years in the field even if the state's courts change the rule. And many important easements, such as cross easement agreements in shopping centers, cannot be adequately described.

As the Reporter points out above, the developer bought this property with knowledge of the easement, and likely paid a price taking the easement into account, and then immediately commenced to push the easement aside. Where is the economic benefit in this practice?

The Reporter for this item was Daniel Bogart at the Chapman Law School.

EASEMENTS; TERMINATION BY ADVERSE POSSESSION AND ABANDONMENT. Owner of easement did not abandon or lose easement by adverse possession even though owner of servient tract parked cars and trailers on easement driveway, (mostly) blocked it with large rocks, and ultimately built an electric fence. ***Johnston v. Cornelius, 2009 WL 2871151 (Or. Ct. App. 2009).***

Cornelius owned lot 601 allegedly subject to a 30-foot wide roadway easement. Johnston owned lot 701, the alleged dominant tract. The parcels at issue were part of a larger tract of land known only as the "Southwest Quarter." Swalley Road ran along the northern and western edges of the Southwest Quarter and provided access to many of the homes in the subdivision to the public roads. Lot 701 was not immediately adjacent to lot 601; lot 703, owned by a third person non-party, Curry, sat between the two.

The case opinion recited the involved history of the property. Wilsons acquired four lots, including lot 701, from Rollie and Alma Roach in March of 1974. The deed from Roaches to the Wilsons also granted Wilsons a roadway easement across lots 500 and 601, along the southern boundary of the two lots. The easement was appurtenant and not in gross. However the deed conveying the lots and the easement was ambiguous in one important sense: "it did not specify whether the easement was intended to benefit any particular portion of the property conveyed.

Wilsons built a house on lot 703, part of the property they retained, and used the driveway across lot 500 and 601 to reach Swalley Road through a driveway built on the easement. Apparently, Wilsons owned enough of the property that they could sell off portions over time. Wilsons sold other lots, including lot 701, by a deed that did not mention the roadway easement.

Ultimately, Wilsons sold a portion of that property – lot 703 – to Trink. Trink also used the driveway to reach Swalley Road. However, in 1985, Trink acquired an additional lot in the subdivision that maintained separate access to public roads, which according to the court, "they then used as their primary access to Swalley Road." In other words, Trink – owner of lot 703 which sat between Cornelius and Johnston's lots — essentially stopped using the easement in 1985. Trink also constructed a fence on their property (lot 703) which

made it impossible to use the easement across lot 601. "Plaintiffs [Johnstons] did not object to the fence blocking any potential vehicle passage across lot 703 for at least 12 years after they bought their property.

Curry purchased lot 703 from Trink. The opinion noted that Curry used the easement driveway on "several occasions," but that is about it. In other words, the fence on lot 703, the property lying in between lot 601 and lot 701, was a barrier to use of the easement, but the individuals owning lot 703 occasionally used the easement.

Cornelius purchased lot 601 in 2001. When Cornelius purchased lot 601, he was apparently aware of the roadway easement. However, Cornelius's lawyer told him that the easement was no longer valid. (That advice certainly bred considerable litigation.)

Between 2001 and 2004, both Cornelius and Johnston parked cars and trailers on the easement driveway from time-to-time, and "large rocks were piled" onto the border of the easement. (The opinion does not tell us who placed the rocks on the easement land, only that this occurred when neighboring property was cleared for agricultural uses.) The pile of rocks extended "between 15 and 20 feet onto that lot – that is, onto the easement." In addition, Curry built a fence on lot 703 that partially obstructed the easement driveway.

In 2004, Johnston applied for permits to allow Johnston to subdivide his property and to build a house on lot 701, which Johnston intended to sell. Johnston argued that the easement across lot 601 would afford the purchaser of the new home access to the road. Johnston argued that the easement created by the 1974 warranty deed "provided access to the entire property conveyed in the deed-including lot 701- they asserted they had a right to the easement." There was evidence that Cornelius may have moved the large pile of rocks directly onto the driveway easement area after Johnston filed for its subdivision permit.

Curry, owner of the intermediate lot, agreed to remove the portion of the fence that blocked the ability of Johnston to cross lot 703, although Curry refused to sign an express easement in favor of lot 701.

Cornelius "strenuously objected" to the easement right claimed by Johnston. He backed up his strenuous objection with feisty behavior: "At some point, they [Cornelius] placed an electric fence across the easement." Indeed, Cornelius "continued to park vehicles and trailers in the driveway. Potential buyers who went to the address listed with the realtor for lot 701 would not have been able to reach it from that driveway."

The Cornelius's fierce reaction to the purported easement covering their property caused Johnston to bring an action for "interference with easement." Cornelius responded that the easement had either been terminated because it had been abandoned, or because it had been adversely possessed.

The trial court ruled in favor of the owner of the servient tract – Cornelius. The court agreed that the easement had been terminated by abandonment or because of adverse possession. The Oregon Court of Appeals reversed on both counts.

The court of appeals listed the elements of adverse possession in black letter fashion, then found that the elements were not met. Under Oregon Law, an easement may be extinguished by adverse possession if the servient owner demonstrates, "by clear and convincing evidence, that their use or occupancy of the easement was actual, open, notorious, exclusive, continuous, and hostile for a 10-year period. In addition, the servient owners must show that their use or occupancy was inconsistent with the dominant estate owner's use of the easement."

In Johnston, the court held that the use was not continuous, because "intermittently" owners of both the dominant and servient lots blocked access to the easement with vehicles. Sometimes a car would be blocking the path and sometimes it would not be.

The pile of rocks sat on the path for the required time period (10 years), but "it did not block the path entirely." Therefore, according to the court, the rock pile was not inconsistent with the use. We are not told in the opinion just how significant an intrusion the rock pile was during this period.

Cornelius argued that Curry – owner of lot 703 — had used the driveway in a manner that was inconsistent with the roadway easement (presumably, the building of a fence that crossed a portion of the easement way.) However, the court held that the behavior of a third party to the action had no bearing at all on whether Cornelius adversely possessed the easement right.

Finally, Cornelius lost the claim that Johnston (or predecessors in title) abandoned the easement. Citing *Shields v. Villareal*, 33 P. 3d 1032 (Or. 2001), the court stated, "the party alleging abandonment must show, by clear and convincing evidence, that the easement holder "expressed or manifested an intent to make no further use of the easement." In Johnston, evidence demonstrated that owner of the dominant tract did (if only very occasionally) walk the easement "yearly for about 10 years." Further, according to the court, neither Johnston nor any other owner of the dominant parcel ever voiced a desire to abandon the easement. The court pointed repeated black letter easement law that mere non use of the easement for a period of time – even an extended period – does not qualify as abandonment.

According to the court, the only behavior that might act as abandonment was the Wilsons' original subdivision of the property (three lots, including lot 701). Citing Restatement (Third) of Property (Servitudes) §5.7 (2000), the court explained that, when property benefited by an easement is divided, the subdivider may apportion easement rights to some of the property and abandon the easement as to the rest. However, the court stated that nothing in the original subdivision suggested that Wilsons intended to abandon the rights vis-à-vis lot 701. Indeed, the easement was necessary to reach Swalley Road.

Because the facts of record showed that Cornelius backed up his discontent with an electric fence, the court granted the plaintiffs an injunction requiring its removal (and removal of any vehicles parked on the property) that impeded the easement. The trial court dismissed the Johnston's demand for damages. The court therefore remands for a determination as to provable loss by Johnston.

Reporter's Comment 1: Johnston probably should make tracks quickly across Cornelius's lot when driving to Swalley Road. This is not a happy arrangement. Electric fences are meant to cause physical harm and Cornelius was apparently willing to vent his frustration in this fashion. ***Editor sez***: Life moves on. . . . Peace will come.

Reporter's Comment 2: This case pushes to its limits the idea that a long dormant easement continues in existence despite non use. The facts show that the easement was not used for substantial periods of time, that both the owners of the servient and dominant tracts parked cars and trailers on the property from time-to-time blocking access, that rocks were piled on the easement area and that an owner of an intermediate tract fenced off access. ***Editor sez***: So the rule is proved. The Johnsons had little use for the easement until they developed another portion of their land – then they did. Why should they be deemed as abandoning it? The editor believes the case is perfectly consistent with abandonment doctrine.

Reporter's Comment 3: As to adverse possession, the court takes the view that the party interfering with the easement must totally block access to make its claim. Cornelius and his predecessors set up a pretty elaborate obstacle course over time, even prior to the electric fence, but this was not enough to meet the court's test. ***Editor sez***: Significant blockage has been enough in the past, but it is not clear that there was ever enough to block, for instance, vehicular traffic. This was a 30-foot roadway.

The Reporter for this item was Daniel Bogart at the Chapman Law School.

EASEMENTS; TERMINATION; MERGER: Although existing recorded easement may be terminated by merger of the dominant and servient estate in the same owner, the easement may be revived by reference to the record in the documents related to the sale of one of the estates. ***Shah v. Smith, 908 N.E. 2d 983 (Ohio App. 2009).***

This case is discussed under the heading "Vendor/ Purchaser; Merger by Deed."

EMINENT DOMAIN; DAMAGES; BILLBOARDS; ADVERTISING REVENUES: When making the determination of adequate compensation after the state condemns an easement used for billboard advertisements, expert testimony assessing the market value of the easement should not include the advertising revenues generated from the use of the easement. ***Texas v. Central Expressway Sign Assoc., ___ S.W.3d _, 2009 Westlaw 1817305 (Tex. 2009).***

The State condemned a 3,950-square foot parcel of land in Dallas in order to improve a highway interchange. Within this land was most of a 1,801-square foot easement held by Central Expressway Sign Associates ("CESA") for the operation of a billboard. This easement was leased to Viacom Outdoor, Inc. ("Viacom"), who, in turn, sold advertising on the billboard. The billboard generated $168,000 per year in advertising revenue. The State

settled with Viacom by agreeing to pay for its relocation. In its suit against CESA, the State called an expert witness who used the "income approach" in his valuation of the property, estimating future rental income generated by the property and applying a capitalization rate. Under the calculation, the estimated fair market value of the easement was $359,817. The trial court found this testimony unreliable and excluded it because the appraisal did not include the advertising revenues from the billboard. CESA's principals included the figure of such revenues in their estimates and concluded the easement was worth $2,500,000. The jury found the value to be $1,850,000 and judgment was entered in that amount. The State challenged the exclusion of its expert and the Texas Court of Appeals affirmed the jury's judgment.

On appeal to the Texas Supreme Court, the court began by outlining the three recognized methods for determining market value of condemned property in Texas, all designed to approximate the amount a buyer would pay a seller for the property. The comparable sales method is preferred, but where (as here) comparable sales figures are not available, the cost or income approaches or the income approach are acceptable. The cost approach takes the cost of replacing the condemned property and subtracts depreciation. The income approach, which was used in this case, values the property according to the rental income it generates.

In *Herndon v. Housing Authority*, 261 S.W.2d 221 (Tex. Ct. App. 1953), the Texas Court of Appeals held that generally, adequate compensation does not include profits generated by a business located on condemned land. However, Texas courts have recognized some exceptions to this general rule. Specifically, income from a business operated on the property can be considered into the calculation in a condemnation proceeding if (1) the taking, damaging or destruction of property causes a substantial interference with the access to one's property, or (2) when only part of the land has been taken, so that lost profits may demonstrate the effect on the market value of the remaining land and improvements.

While the taking here did not fall into either of the foregoing two exception categories, the Herndon court (after stating the general rule) cited several cases from other states and noted that evidence of "rents and profits derived from the intrinsic nature of the real estate itself" would be admissible in an action to determine a condemnation award. Based on the qualification in the Herndon case, CESA argued that the advertising income was derived from the intrinsic value of the land and should, therefore, be treated like rental income. In examining case law from other jurisdictions, the court discussed a split, with those jurisdictions not allowing evidence of business income holding that the revenues are too speculative to be properly included in the estimation and that revenues attributable to the sign's location can be reflected in the fair rental value. The court also noted that in similar Texas cases involving various other business ventures, courts have not recognized the exception for considering business profits "derived from the intrinsic nature of the real estate."

Here, the court held that the exception should not be created in this case, as there was nothing to indicate that a billboard's location is more significant to business than location was in any of the other cases in which Texas courts declined to recognize the exception. Additionally, the rent CESA charged for the space was significantly less than the amount of profit being generated through advertising sales, implying that the profit was particularly high because of business skill exercised by Viacom rather than the location of the billboard. Had the profit been entirely due to the location, CESA could have charged rent much closer to the level of profit. Even if CESA were, in fact, undercharging for rent, the appraisal of the State's expert still would not undervalue to property because it adds the "bonus value" of the lease to rental income. Bonus value is the value of the leasehold's use and occupancy for the remainder of the tenant's term, plus the value of any renewal right, less the agreed rent. The State's expert, deciding that Viacom was paying rent comparable to what it would at a similar property, calculated this value as zero.

CESA further argued that the expert's appraisal violated the "undivided-fee rule," which mandates that the property be valued as if owned by a single party rather than as the sum of the interests of different parties. CESA argued that, because the expert assigned Viacom's leasehold no value, he had impermissibly divided the whole into parts while making his calculation. The court held that this argument misinterpreted the rule, which the appraisal did not violate. The purpose of the rule is to ensure that the approximation is for what the entire property would sell for in a market transaction, not to guarantee that all individual interests are assigned a value greater than zero. The appraisal here did not overlook the value of the property as a billboard location and valued

the easement as put to its highest and best use. Therefore, the testimony of the State's expert used an acceptable method to appraise the value of the easement and should not have been excluded.

Ultimately, the court held in reversing the court of appeals' holding that CESA's principals should not have been allowed to include evidence based on advertising income in their valuations, but would be allowed to offer general estimates of a price for which the property could sell given its potential use as a billboard site.

Comment: This decision seems correct. The owner of the easement was receiving considerably less than the advertising revenues, and the court properly concluded that the value of the billboard space to the owner of the land was the billboard lease rentals, and not the value of revenues earned by the billboard lessee. The highways are full of billboards advertising "lease this space." The advertising value of a billboard location is certainly real, but it is reflected in the lease, not in the revenues.

ENVIRONMENTAL LAW; LENDER LIABILITY: Mortgagee not liable when mortgagee fails to pass on to borrower environmental report that lender deems to be satisfactory in making loan, but may have provided clues that borrower could have pursued in identifying contamination. ***Robert Hull and Point Pleasant Landco v. William Lewis (No.A-005403-07T3, App. Div.6/11/09)***, discussed under the heading: "Lender Liability; Environmental Law".

EMINENT DOMAIN; DEPRIVATION OF ACCESS: Even though owner retains access to property, state's action that "substantially or unreasonably" interfered with commercial use by depriving owner of a second access point which permitted "flow through" of traffic amounted to taking within meaning of state constitution. ***State ex rel Thieken v. Procter, 904 N.E.2d 619 (Ohio App. 10 Dist).***

The Ohio Department of Transportation ("ODOT"), appealed from a judgment of the Franklin County Court of Common Pleas in favor of Thieken.

In 2001, the Department of Transportation initiated a project to improve the portion of State Route ("S.R.") 7. Thieken owned a property on the north-west corner of the intersection of S.R. 7 and S.R. 775. From 1996 to 2006, Thieken leased his property to John W. Clark Oil Co., Inc., which operated a Marathon gas station/convenience store on the property. The convenience store, located to the rear (north side) of the property, faced S.R. 7, and an attached canopy extended from the store entrance almost to S.R. 7.

Prior to ODOT's improvements, both S.R. 7 and S.R. 775 were on the same grade with Thieken's property allowing customers to pull into the gas station from virtually any point at which the property abutted S.R. 7 or S.R. 775. ODOT's plans for improving S.R. 7 included the installation of a six-inch concrete curb along the majority of the southern boundary of Thieken's property. The curb would prevent customers from accessing Thieken's property from S.R. 7 except through a curb cut located on the southwest edge of the property. The curb cut consisted of a 42-foot apron, tapering to a 30-foot driveway.

Thieken initiated a mandamus action in the Franklin County Court of Common Pleas in which he alleged that ODOT's limitation of his access to S.R. 7 constituted a taking and that the Ohio Constitution entitled him to compensation for that taking. Thieken sought a writ of mandamus compelling ODOT to initiate an appropriation action to compensate him for its interference with access to his property.

Both Thieken and ODOT moved for summary judgment based on the evidentiary record developed in the Lawrence County Court of Common Pleas. The trial court granted ODOT summary judgment and denied Thieken summary judgment. Thieken appealed that judgment to the court of appeals. Finding that the parties presented conflicting evidence as to whether ODOT substantially or unreasonably interfered with Thieken's right of access, the court or appeals reversed the trial court's judgment and remanded the case to that court. On remand, the trial court conducted a bench trial and issued judgment in favor of Thieken.

The Ohio Constitution prohibits the state from taking private property for public use without just compensation. Section 19, Article I, Ohio Constitution. A "taking" occurs when the state substantially or unreasonably interferes with a property right. *State ex rel. OTR v. Columbus*,76 Ohio St.3d 203, 206, 667 N.E.2d 8 (1996). One of the elemental rights of real-property ownership is the right of access to any public roadway abutting the property. Id. Therefore, any governmental

action that substantially or unreasonably interferes with the right to access abutting roadways constitutes a taking within the meaning of Section 19, Article I of the Ohio Constitution. OTR at syllabus. When the state completely deprives a property owner of all access to an abutting road- way, the state has substantially or unreasonably interfered with the right of access. *McKay v. Kauer*, 156 Ohio St. 347, 46 (1951).

However, a taking can occur even if the state's interference does not amount to a total obstruction of access. Courts have also found a substantial or unreasonable interference with the right of access when the state blocks an existing access point so as to create circuity of travel within a property. *Hilliard v. First Indus., L.P.*, 158 Ohio App.3d 792, 2004. "Circuity of travel within one's own property occurs when one entrance or exit way is removed and another is not created." First Indus., L.P., at 8. Thus, when a property owner has two entrances from an abutting roadway, and the state blocks one of the entrances without supplying an additional entrance, circuity of travel within a property results. Thieken's property essentially had two wide entrances off S.R. 7 before ODOT installed curbing along that roadway. Customers could access the property either through the "eastern entrance," or the "western entrance" of Thieken's property. By installing a curb along Thieken's property boundary, ODOT completely blocked the eastern entrance and limited the western entrance to a 42-foot curb cut, tapering to a 30-foot driveway.

The Appeals court concluded that the trial court properly determined that ODOT substantially or unreasonably interfered with Thieken's right of access when it created circuity of travel within Thieken's property and overruled ODOT's first assignment of error.

ODOT argued that the trial court erred in allowing testimony about the highest and best use of Thieken's property and in relying upon that testimony to reach its decision. Although the trial court found that ODOT destroyed the highest and best use of Thieken's property, the appeals court did not conclude, that the trial court's decision "hinged" upon that finding, but, rather, that the trial court decided that ODOT substantially or unreasonably interfered with Thieken's right of access for two reasons: (1) ODOT created circuity of travel within Thieken's property and (2) a change in the highest and best use of the property. Since the Appeals court concluded that the trial court's first reason is both legally correct and supported by the evidence, they had no need to address any alleged error underlying the second reason.

Comment: DIRT has reported many cases over the years in which landowners who retained some access to their property were not able to argue a taking when other access was restricted. The Ohio rule, here, seems somewhat more protective of the landowner. The editor has not seen the "circuity of travel" argument used before, but here it appeared to be of great effect.

EMINENT DOMAIN; INVERSE CONDEMNATION; UTILITY RELOCATION EXPENSES: A utility that maintains facilities in a public right-of-way has no vested property interest in the right-of-way, and therefore is not entitled to assert inverse condemnation if it is forced to relocate such facilities. ***Southwestern Bell Telephone, L.P. v. Harris County Toll Road Authority, ___ S.W.3d ___ (Tex. 2009).***

Southwestern Bell Telephone, L.P. (ASBC"), which provides local telephone service throughout Texas, maintains underground telecommunications facilities in a public right-of-way along Westpark Tollway as permitted by and in accordance with certain Texas statutes. When Harris County Toll Road Authority and Harris County (collectively, the "County") began construction of the Tollway in 2001, it required SBC to relocate its facilities in the right-of-way. SBC did so and then billed the County for its costs. When the County failed to pay, SBC sued, asserting a statutory claim for reimbursement and a constitutional claim for inverse condemnation. The trial court granted SBC's motion for summary judgment, and the court of appeals reversed on the grounds that the County was immune from suit on the statutory claim and that SBC had no vested property interest in the right-of-way for purposes of the constitutional claim. SBC appealed to the Texas Supreme Court.

On appeal with respect to the constitutional takings claim, SBC argued it was entitled to compensation for its relocation expenses under the takings clause of the Texas Constitution. Specifically, the issue was whether the County's actions resulted in a "taking" of property. The Texas Supreme Court began with a reference to a 1905 U.S. Supreme Court case in which the Court rejected a taking claim brought by a gas company forced to relocate pipes to accommodate improvements to a city's drainage system and held that "a utility forced to relocate from a

public right-of-way must do so at its own expense," in the absence of an agreement or statute to the contrary. SBC argued that notwithstanding this general rule, the statutory authority given to it to "install a facility . . . in a manner that does not inconvenience the public in the use of the road, street, or water" granted it a property interest on which a taking claim may be based, and that the statute granted telephone companies "[i]n effect, . . . a private easement."

When addressing SBC's argument the court first cited a noted treatise which recognizes that:

> The authorization to maintain rails, etc., in a particular part of the highway is not an easement or an other estate or interest in the land so occupied, [but is] merely a license to share in the public easement, and consequently a corporation maintaining rails, pipes, and wires in a public highway is not entitled to compensation for an invasion under legislative authority of the portion of the highway occupied by its structures. . . . ***[W]hen the continued undisturbed existence of the licensed structure interfere[s] with some other public need, the disturbance or removal of the structures or an alteration of their location is not a taking or even a damaging of property.*** The permission to use the highway or such structures has been granted upon an implied condition that the structures shall not interfere, either at the time that they are placed in position or thereafter, with any other public use to which the legislature sees fit to devote the way."

In addition, the court cited a 1970 Texas Court of Appeals case in which the court rejected a telegraph company's taking claim, "despite the fact that lines had been installed forty-three years earlier pursuant to [the subject statute's] predecessor; right to use the streets was a 'permissive right' not a 'vested' one, and utility had to bear its own relocation costs."

Despite this case law, SBC argued telephone companies are different from other utilities, particularly since the statute is silent on relocation costs when other statutes explicitly require utilities to pay relocation costs in other circumstances. To this argument, the court held that "the statute's silence on relocation costs would mean that the common law rule applied, not that the county was responsible for relocation costs." Because no Texas case has concluded that utilities have a right in the public roads that is compensable under the Texas Constitution, the court here concluded that SBC would be required to bear its own relocation costs.

GUARANTEES; "BAD BOY" CLAUSES: Once a Non-Recourse Carve-Out is triggered, it doesn't matter that is cured or that its occurrence in the first place had no effect on the lender; the borrower and each guarantor otherwise protected from liability for the borrowed amount become liable for the entire outstanding loan; and the amount thus collectable will not be characterized as liquidated damages. ***CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, A-6307-07T2, 2009 WL 2431530. (N.J. Super. App. Div. 2009)****;* August 11, 2009, discussed under the heading: "Mortgages; Guaranties; Carve-outs; Liquidated Damages."

INSURANCE; FIRE INSURANCE; SUBROGATION; WAIVERS; CONSTRUCTION COMPLETION CLAUSE: Construction contract provision that there would be waiver of subrogation to extent of "other insurance applicable to the Work," did not extend the period of waiver to periods following construction even when the owner had obtained insurance. Insurer not barred from subrogation claim. ***Hartford Underwriters Insurance Company v. Phoebus, 2009 WESTLAW 2713237, (Md. Ct. Spec. App. 8/31/09)*** **(not yet released for publication.)**

A construction contract for a fast food restaurant required the owner to maintain during the construction an "all risk" policy, including builder's risk. This insurance was to be maintained during course of construction and until final payment "or until no person or entity has an insurable interest in the property."

This language was followed in the contract by a waiver of subrogation clause that stated that there was a mutual waiver of "all rights" "for damages caused by fire or other causes of loss "to the extent covered by property insurance obtained pursuant to [the language described above] or other property insurance applicable to the Work, . . . the policies that provide such waivers of subrogation . . . ."

"Work" was defined in the contract as "the construction and services required by the Contract Documents,

whether completed or partially completed. . . . The work may constitute the whole or part of the project."

This definition is similar to AIA form contract language.

One last piece of the contract – the "final completion and final payment clause," stated:

"The making of final payment shall constitute a waiver of claims by the others except those arising from:

2) failure of the Work to comply with the requirements of the Contract Documents;"

Two and a half years later, a fire broke out, causing over a million dollars in damages. Owner alleged that the cause of the fire was defective electrical work. It was paid for the damages by its new property insurer, which then brought a suit in subrogation against the Contractor.

On summary judgment, the trial court ruled that the waiver of claims and waiver of subrogation clause was effective because it applied to "property insurance applicable to the Work," and because this intent of the parties was not disclaimed by the reservation of rights set forth in the "final completion and final payment clause" as an exception to the waivers contained in that clause. Summary judgment to Contractor.

The Special Court of Appeals reviewed the question of whether the contract was ambiguous *de novo.* The insurer argued that it was ambiguous – that it was unclear whether the parities that any insurer, ever in the future, would be viewed as waiving subrogation against the Contractor for construction defects, particularly in light of the reservation of rights to sue for (in effect) construction defects in the "final completion and final payment clause."

The appeals court first stated that the question boiled down to whether the completed restaurant was part of the "Work" as defined above. It noted that language contained in a typical "Complete Project Insurance" clause" in other construction contracts would have plainly included a waiver of subrogation for the contractor for the completed project. This clause, more specific than the language in the case at hand, has been upheld in a number of decisions in Oregon, Georgia and Texas and Indiana. All of these cases contained the AIA definition of "Work" and the court ruled that the temporal scope of waivers of subrogation for such work ran beyond the end of the contract.

But in a case in Missouri that did not have a "Completed Project Insurance" clause, the court found that the definition of "work" – albeit the same language – was ambiguous in light of the reservation of rights contained in a "final payment clause" similar to the one in the instant case. The Missouri court denied subrogation protection.

The Insurer stressed the ambiguity that existed when a contract contained by Completed Project Insurance" clause, as in the present case, and argued that the policy considerations supporting a waiver of subrogation – that one policy should be viewed as covering essentially the same risk when both Contractor and Owner have shared interests in the project – does not extend to periods beyond the completion of the project.

The appeals court bought this argument, noting also that another term used in the contract – "Project" – appeared when the parties intended to refer to the completed restaurant, and that the term "Work" didn't necessarily connote the same concept.

Following the general rule that waivers should be read narrowly, the court concluded that the parties to the present contract did not intend to waive claims or subrogation as to damages arising after completion of the project caused by negligent or nonconforming construction practices. Reversed.

Comment: The editor has scant experience in construction law, but his incredible *chutzpa* moves him to make a comment anyway.

The general purpose of waiver of subrogation clauses is the recognition of the fact that the parties share a mutual interest in the same property and that insurance undertaken by one party is likely to cover the same risk of loss faced by the other. Thus, the parties choose to rely on only one comprehensive property damage policy and mutually waive claims and subrogation. The insurer goes along with it because it recognizes that it is still insuring the same risk of loss.

Applied to construction claims, one could assay the argument that both the contractor and owner share a mutual interest in the same property – and that insurance against property damages would cover the same risk –

damage during construction. Is this true as to injury caused by claimed defects following construction? It would appear that some parties in the industry feel that way – hence the "completed project insurance" clause. If the same arguments apply, then certainly there was sufficient language in the instant contract to support the interpretation of the parties' intent reached by the trial court – that subrogation has been waived. As the court does not tell us the policy arguments raised by the Insurer and makes no other analysis of the business practices – but just tries to parse the contract in a somewhat unconvincing manner, the editor finds the decision unsatisfying – sort of like a coconut cream covered sawdust cake.

LANDLORD/TENANT; ASSIGNMENTS; BROKERAGE COMMISSIONS: Although an obligation to pay brokerage commissions appears in a lease and although the lease is stated to bind "successors and assigns," such promise is not a "real covenant" but merely a "personal covenant and is not binding upon assigns of the landlord unless expressly assumed. A general assumption may qualify to bind the assignee if the intent of the parties is clear. ***Pagano Co. v. 48 South Franklin Turnpike, LLC, 965 A. 2d 1171 (N.J. 2009).***

Seller entered into an exclusive brokerage agreement with Broker. With Broker's assistance, Seller had already executed three leases on the property, and each lease contained the following statement:

> "by separate commission and letter of understanding [Broker] shall be paid a commission by Lessor. In consideration of the foregoing, Lessor agrees to fully satisfy its obligations to said broker for commissions and covenants and agrees to indemnify and save lessee harmless with respect to the claims of said broker for said commissions."

The lease commissions were payable according to a schedule over time. Of course, each lease also stated that it bound the heirs, successors and assigns of both lessor and lessee.

Later, Seller sold the property to Buyer subject to the three leases. Seller assigned the leases to Buyer and Buyer agreed to assume the leases: "Assignee hereby assumes and agrees to perform all of Assignor's obligations under the Leases." Although some lease commissions remained unpaid under the schedule, Buyer refused to pay them, claiming that it did not intend by its general assumption of the leases to assume also liability of existing commission obligations of Seller.

The court, citing prior New Jersey authority, noted first that lease commission agreements in leases are personal covenants that do not touch and concern the land and to not automatically bind assignees. The question always is whether the assignee has specifically assumed such agreements. This question must be answered by an analysis of the entire agreement and possibly other facts and circumstances. The burden is on the broker seeking the commission to prove that an assumption occurred.

Here, notwithstanding Buyer's denials, there was nothing in the documentation to suggest that the Buyer a sophisticated business person, should not have bargained for specific language indicating a lack of intent to be bound by the commission agreements if that was its intent. Consequently the court, by a split opinion, found that there had been an assumption.

Comment 1: An interesting question is whether the "exclusive" arrangement continued to bind the Buyer. The case involves only the obligation for existing commissions. A close reading of the language of the leases themselves suggests that only obligations for existing leases were covered.

Comment 2: The dissent argued that there was no agreement between Buyer and Brokers at all.

> "The bar should be high when examining the documents said to contain an affirmative undertaking by the purchaser to pay a broker the fees or commissions that would have been due under the seller's purely personal contract with the broker."

LANDLORD/TENANT; CONSTRUCTIVE EVICTION; WAIVER: Tenant may assert constructive eviction claim against landlord's mortgagee, rents assignee, based upon defects caused by assignor landlord notwithstanding UCC 9-4039(c), tenant's estoppel certificate or "hell or high water" clause in the recognition agreement. ***Reliastar Life Insurance Company of New York v. Home Depot U.S.A.,* Inc.*, 570 F.3d 513 (2d Cir. 2009).***

In late February of 1989, Home Depot entered into a lease with G&S Investors. G&S, as landlord, agreed to construct a building pad for the building, and Home Depot, as tenant, would build that actual facility. G&S constructed an "earthen" pad, and Home Depot constructed the store and opened in December of 1990.

In 1993, G&S mortgaged the property to North Atlantic Life Insurance Co.; Reliastar is the successor in interest to North Atlantic Life. The 1993 mortgage was guaranteed by an assignment of the Home Depot lease. The assignment assigned all rents, income and profits in connection with the lease to the mortgagee. In addition, it required Home Depot to recognize the assignment, and to make all of its rent payments directly to the mortgagee.

Home Depot complied. It executed a Recognition Agreement to Reliastar (this document was drafted by the lender.) It contained the following paragraph 7(a)(which the court calls a "hell or high water" clause):

> "Tenant understands that a substantial inducement for Mortgagee to purchase the Notes is the continuing existence of the Lease, the income stream payable therefrom and the direct payment to the Mortgagee of all rents and other payments due under the Lease and that in furtherance thereof the Mortgagor has by the Assignment assigned its interest in the Lease, the rents and all other payments due under the Lease to Mortgagee as security for repayment of the Note. Tenant agrees that notwithstanding anything in the Lease or this Agreement contained to the contrary, until Mortgagee notify [sic] tenant that the Assignment has been released, Tenant shall be unconditionally and absolutely obligated to pay to Mortgagee in accordance with the Assignment all rents, purchases payments and other payments of whatever kind described in the Lease without any reduction, set off, abatement, or diminution whatever."

In addition, the Recognition Agreement included a tenant estoppel, in which Home Depot stated:

> "d. Tenant has fully inspected the Premises and found the same to be as required by the Lease, in good order and repair, and all conditions under the Lease to be performed by the landlord have been satisfied; including but not limited to payment to Tenant of any landlord contributions for Tenant improvements and completion by landlord of the construction of any leasehold improvements to be constructed by the landlord; . . .
>
> f. As of this date, the Mortgagor, as landlord, is not in default under any of the terms, conditions, provisions or agreements of the Lease and Tenant has no offsets, claims or defenses against the Mortgagor, as landlord with respect to the lease;"

In 1996, things turned sour. Home Depot discovered cracks in walls of the building; the cracks apparently resulted because the foundation built by G&S was "settling unevenly." G&S refused to remediate the problem, so Home Depot unsuccessfully attempted to make repairs. This cost Home Depot $750,000. However, the problems persisted. Home Depot vacated the premises and stopped paying its rent in August of 1999.

Reliastar pursued Home Depot in federal district. Home Depot claimed it had been constructively evicted. The District Court held for Reliastar, on the basis that the 'hell or high water" clause vitiated any constructive eviction defense.

On appeal, the Court of Appeals for the Second Circuit addressed three issues: 1) whether New York's U.C.C. '9-403(c) prohibited Home Depot from asserting its constructive eviction defense; 2) whether the estoppel language in the Recognition Agreement barred the assertion of constructive eviction; and 3) whether the "hell or high water" provision by its terms obligated Home Depot to make rent payments "absolutely and unconditionally." The Second Circuit rejected all of Reliastar's arguments and reversed the District Court.

New York's U.C.C. '9-403(c) provides that an "agreement by parties that the contract can be assigned free of any defenses which an account debtor may have against the assignor is enforceable by a good faith, for-value assignee against ordinary defenses, not including fraud, duress, or the like." The court acknowledged that Reliastar ordinarily would take free of many if not most of Home Depot's defenses under the U.C.C., but the court then equated constructive eviction with "fraud, duress or the like." The court explains "constructive

eviction is similar to the defenses of fraud and duress in that it goes to the very existence of the agreement, rather than a failure to perform in accordance with the terms of the agreement."

Home Depot represented in the Recognition Agreement's estoppel that it had "fully inspected the Premises," and that further the Premises were in "good order and repair." The building pad constructed by the landlord was part of the Premises under the lease. However, the court held that the tenant estoppel did "no more than express Home Depot's knowledge at the time the certificate was executed." This conclusion was reinforced by the lease which required Home Depot to execute estoppels at the landlord's request covering "then existing defaults" of the landlord. The estoppel also limited itself to problems "as of this date." Home Depot's answers to the estoppel were honest and accurate representations because, according to Home Depot, it did not become aware of the problems in the building pad until two years after the execution of the Recognition Agreement.

Finally, the lease contained a provision – the "hell or high water clause" – that required Home Depot to make its rents payments to landlord "unconditionally and absolutely." These clauses are generally enforceable in New York when asserted by good faith assignees against sophisticated parties unhappy with some outcome of the contractual arrangement. Apparently, however, (at least as understood by the federal court of appeals) these provisions had only been interpreted in the context of finance and equipment leases, and not real property leases. The court parsed the language very, very carefully: "The main force of the guarantee, however, is the payment of "all rents" and the description of "rents" as "due under the Lease."" According to the court, constructive eviction terminates the lease and relieves the tenant of rental obligations, and therefore, the hell or high water clause was held ineffective.

Reporter's Comment 1: The court's very technical reading of the hell or high water provision suggests that landlord attorneys may need to be more specific about their intention to limit the tenant's defense of constructive eviction when drafting provisions unconditionally requiring tenant's payment of rentals. This is not necessarily an easy task. According to '29.3.3 of Friedman on Leases, provisions in which a tenant simply disclaims its right to assert the defense might be deemed to offend public policy. The treatise also cites §5.6 of the Restatement (Second) of Property that empowers the landlord and tenant to increase or decrease landlord's obligations and the remedies of the tenant unless the agreement is unconscionable or against public policy.

Reporter's Comment 2: Early on, the court equates constructive eviction with defenses of duress and fraud. It is this comparison that allows the Home Depot to evade application of U.C.C. '9-403(c). The reporter is not entirely comfortable with the comparison. Constructive eviction grew from the more basic defense granted to a tenant when the tenant was physically evicted from the premises by the landlord. Physical eviction interfered with the single dependent covenant lease law recognized: quite enjoyment. In time, courts recognized that some failures of the landlord, while not actual physical evictions, might be so significant that they all but required the tenant's quick departure from the premises. Such constructive evictions also provided a defense to landlord's demand for rents. Today, tenant's constructive eviction does not usually result from landlord's tortious behavior (although the landlord's behavior in some instances might be tortious). Often, these evictions are at best just really bad breaches of the lease agreement (failure to provide water, AC, etc.)

Reporter's Comment 3: The court vacates the district court's decision that Home Depot had no constructive eviction defense and remands for further determination. The record is therefore not fully developed in the opinion. That said, and based only on the facts presented in the opinion, the reporter wonders if Home Depot will sustain the defense. Home Depot became aware of the problem in the foundation and informed its landlord, which refused to take any remedial steps. Home Depot then spent hundreds of thousands of dollars on repairs, only to decide, based on the recommendation of its structural engineer, that the condition had not been fixed. Home Depot then ceased paying its rent and vacated. Presumably, Home Depot had a structural engineer make recommendations before doing its costly repair work, and would not have done so unless it was told that the repairs would or could be successful. Normal constructive eviction doctrine requires the tenant to vacate ASAP, or lose the ability to assert the defense.

Reporter's Comment 4: It is worth noting that this is a federal court's interpretation of state property law. While valuable, it is not binding on the New York Court of Appeals.

Editor's Comment: The law of independence of covenants, which gives rise to the constructive eviction doctrine (because an "eviction" is an exception to the rule of independence of covenants), is under assault in a number of quarters. Massachusetts has already abolished it, and there have been some cases in New York as well.

This case is based upon the traditional notion that a constructive eviction is a breach of possession that terminates the lease. If the notion were simply that a major breach of lease affords a tenant a right of rescission, would the same analysis apply here. Maybe. But maybe also contract principles would be applied more carefully to the interpretation of waivers as well.

The Reporter for this item was Professor Daniel Bogart of the Chapman Law School.

LANDLORD/TENANT; COMMERCIAL; EXCLUSIVE USE CLAUSES: Exclusive use clause that does not contain express limitations as to time or product line can provide "open ended" protection for any changes tenant or tenant's affiliate stores may undertake in their product line during the life of the lease. ***Interstate Realty v. Sears, Roebuck & Co., Civ. No. 06-5997 – DRD, 2009 Westlaw 1286209 (D. N.J. 4/27/09)*** **(not approved for publication).**

In 1996, Sears negotiated for a long term lease of 42,000 square feet in Owner's shopping center. The original (non binding) memorandum of understanding contained the following provision relating to exclusive use: "[f]or so long as Sears operates a Sears Hardware store, Landlord shall not lease to another tenant whose principal business is paint, hardware and/or lawn and garden supplies."

When the final lease was signed, however, the language concerning exclusive use was pretty much the standard language Sears used in its leases (if it could get away with it):

> The Demised Premises may be used by Tenant for the sale, servicing and storing of merchandise, all other items or services normally sold in Sears Hardware Stores, and all other lawful retail uses.
>
> Landlord represents and warrants to Tenant that Landlord shall not lease any portion of the Entire Tract to any tenant who intends to use more than three hundred (300) square feet of its leased premises, in the aggregate, for the sale of certain items or services which would normally be sold in a "Sears Hardware Store," [an exception expanded the permitted competing space for very large leases] Landlord represents and warrants that Landlord shall include a restrictive covenant in all future leases or amendments to leases relating to the Entire Tract which [sic] restricts all other tenants in the Entire Tract from using more than three hundred (300) square feet of leased premises, in the aggregate, [1000 square feet for larger leases] for the sale of items normally sold in "Sears Hardware Stores," including, without limitation, the sale of hardware materials, tools and supplies, paint, plants, and power and non-power lawn and garden equipment, tools and supplies. In the event that any tenant at the Entire Tract shall engage in such sales in violation of the aforesaid exclusive use provision, then Landlord shall take all matters which are necessary in order to enforce for the benefit of Tenant such exclusive use provision, including, without limitation, the filing of any lawsuit at Landlord's sole expense. . . .

In 1995, Sears Hardware Stores nationwide did not sell appliances such as stoves and refrigerators, but did sell outdoor grills. When the Sears store opened at Owner's center, it also sold a range of hardware products and outdoor grills, but no appliances.

In 2004, Sears changed the name of its store in Owner's center to Sears Hardware and Appliance store and commenced selling home appliances. This was consistent with a nationwide strategy relating to a number of Sears Hardware Store locations.

In 2006, pursuant to negotiations it was conducting with Karls, an appliance retailer, Owner asked Sears to sign a letter confirming that the sale of washers, dryers, refrigerators, stoves, etc. did not conflict with Sears' exclusive rights clause. Owner had already asked Karls to agree to sign a covenant that it would not violate the terms of any exclusive rights clause in the center, and Karls obviously had questions about Sears' position.

Sears promptly processed the request, and apparently concluded that the sale of appliances did violate its

exclusive. In fact 80 percent of the Sears Hardware stores in New Jersey had been converted to Sears Hardware and Appliance Stores. Although Karls primarily sold "high end" appliances, Sears elected to invoke what it felt were its rights under the clause, and refused to consent to the leasing to Karls. There was some discussion about limiting the "exclusive" prohibition to appliances that were not "high end" and more directly competed with the Sears line, but this did not appear to go anywhere.

Owner took the position that Sears no longer operated a Sears Hardware Store and had not exclusive rights, but if it did have such rights, they were limited to the product line at the original store as it existed in 2006. Karls reached agreement with Sears that Sears would seek declaratory relief and indemnify Karls if the court did not vindicate the Karls lease.

Sears argued the opposite extreme, contending that the Exclusive Use Clause gives it the exclusive right to sell whatever is normally sold in Sears stores, or even what is normally sold just at Owner's location, at the time in question – no matter whether the Sears stores are Sears Hardware Stores or have been changed to Sears Women's Shoe Stores.

While it was suing anyway, Owner elected to include counts for breach of the duty of good faith and fair dealing (an important issue in New Jersey), tortious interference with prospective economic advantage, and tortious interference with contract.

The court ruled that neither side was correct in its interpretation. It found that Sears was entitled to protection for any product line sold in Sears Hardware stores anywhere such stores might be located, and was not limited to protection of items sold on the Owner's premises. Further, the court ruled that there was no time restriction on the exclusive rights protection, so that Sears was free to change its product line and enjoy protection for the new product line throughout the life of the lease.

But, contrary to Sears somewhat strained argument, the court ruled that Sears could not change the name of its store location and continue to enjoy protection for whatever products it decided to sell under the new name: "Sears is correct that nothing in the Sears Lease prevents it from changing the name of its store and the products it sells at Cedar Knolls, but it does not follow that the Exclusive Use Clause will expand to cover the products sold at its new store, unless those products are normally sold at Sears Hardware Stores generally . . . [Sears] does not have the exclusive right to sell appliances because it changed its store to a Sears Appliance and Hardware Store. Rather, the Sears location at [Owner's Center] still has exclusive rights to sell products normally sold at "Sears Hardware Stores" all over the country, even though it is now a Sears Appliance and Hardware Store.

As to the tort claims, the court found that Sear's interpretation of its rights, although incorrect, "were not so unreasonable as to be malicious."

Comment 1: In the editor's mind, Sear's interpretation of the lease, held through a court proceeding, is pretty close to malicious. It had deliberately changed the name of its stores because no one would come to a hardware store looking for a broad line of appliances. And it seems beyond argument that the only protection it got from the exclusive rights clause was for a "Sears Hardware Store."

Comment 2: The primary reason the editor included this trial court decision, however, is to give fair warning to landlords as to how courts are likely to interpret exclusive rights clause that are open ended as to when the exclusive rights are identified, and open ended as to the product line protected. Although Sears didn't get away with blocking the Karl's lease, there are any number of other potential tenants who might be intimidated by signing a covenant stating what they would have to abandon an important product line any time a Sears Hardware Store somewhere in America picked up that line.

Comment 3: Many exclusive use clauses are negotiated primarily by property managers and are not seen as legal issues. Indeed, disputes in most cases are renegotiated and compromised. Sometimes, however, parties will dig in, and generally they would have been much better off if lawyers had reviewed the clause originally.

LANDLORD/TENANT; FIXTURES: Even when tenant is required to erect building according to approved plans and specs, and then to return building at lease end, HVAC installation shown on the plans is not part of the "improvements" to be returned, but rather a fixture, and Tenant is not responsible for its condition. ***C.W. 100 Louis Henna, Ltd., v. El Chico Restaurants of Texas, L.P., 2009 WL 2902735 (Tex. Ct. App. Aug. 27, 2009).***

El Chico entered into ground lease with Boardwalk Center in September of 1996. Boardwalk assigned its interest to Henna in April 2006. Pursuant to the lease, El Chico agreed to construct a restaurant building on the leased property. The ground lease obligated El Chico to construct the Improvements according to plans and specifications approved by the landlord, Boardwalk. The lease defined Improvements to include "building and other improvements and appurtenances that may hereafter be erected." The lease described the use: "restaurant, a related cocktail lounge, and such other uses as are incidental to the operation thereof and for any other purpose. . . ."

The ground lease was to run for a ten year term, and gave El Chico the ability to renew for four successive five year periods.

According to the lease, El Chico did not have the right to remove or demolish the structure it agreed to build, and was required to carry insurance on the Improvements. El Chico was required to return the property to the landlord at the end of the Term "in good repair and condition, loss by fire or other casualty, condemnation, act of God, ordinary wear and tear excepted." At the end of the Term, the Improvements were to become property of the landlord.

At about the time that Boardwalk assigned its interests as landlord to Henna, El Chico ceased operating a business in the premises. El Chico informed Henna that it had ceased business at the site and further, that it would not exercise its option to renew at the end of the term. To make things easy on Henna, El Chico stated in its letter to Henna that it would not interfere with the marketing or showing of the property and would execute a termination agreement prior to the expiration date of the lease if Henna found a new tenant or sold the property.

Henna purchased all of El Chico's "furniture, fixtures and equipment" in June 2006. Henna's purchase agreement stated that it acquired this material "AS IS." Henna assumed responsibility for utilities, security and other carrying costs for the property. El Chico continued to make base rent payments.

Then the inevitable problem arose.

In January of 2007, prior to the end of the term of the lease, Henna learned that the rooftop air conditioning units on the building constructed by El Chico had been vandalized. Apparently "copper thieves" stripped the units of valuable wiring and conduit. In addition, the units had been damaged by hail. The damage was estimated to equal $38,496.

There were several issues at play in the case, but the one that is most interesting here has to do with the proper designation of the HVAC units. Henna argued El Chico was obligated to repair or keep insured the HVAC units and that therefore El Chico breached the lease contract. El Chico responded that the HVAC units were fixtures that Henna purchased "as-is." The trial court agreed with El Chico, and the Texas Court of Appeals affirmed.

The lease apparently used the word "fixtures" without defining it. According to the court, the failure to specify what fixtures meant for this particular lease transaction indicated the parties' intent to incorporate the conventional understanding of the term. Paragraph 12 of the lease permitted the tenant to take "removable fixtures" at the end of the term as well as personal property "provided that Tenant repairs all damage to the Improvements caused by such removal." This, according to the court, is "consistent with the common meaning of trade fixtures in Texas law, "trade or business fixtures" under the lease are considered to be removable personal property." The same provision of the lease excluded fixtures from the definition of Improvements.

As noted, the lease required El Chico to return the Premises and Improvements at the end of the term in good repair and condition. Furthermore, Tenant was required to maintain the Improvements.

El Chico's lawyers did a good job of conveying their view of facts of the case. According to the opinion, although rooftop HVAC units had a 45 ton air conditioning capacity, and made the restaurant use of the Premises possible. "The units were not attached to the building . . . so that they could be removed and replaced without injury to the building." Furthermore, according to the opinion, the HVAC units provided "many times greater than that needed if the building were to be used for other retail or office use." The inference is that El Chico could legally remove the HVAC units, and that the landlord, or the next tenant, would install replacement rooftop units more suited to the subsequent use.

Texas courts have defined trade fixture to mean "such articles as may be annexed to the realty by the tenant to enable him properly or efficiently to carry on the trade, profession, or enterprise contemplated by the tenancy contract or in which he is engaged while occupying the premises, and which can be removed without material or permanent injury to the freehold." *Boyett v. Boegner*, 746 S.W. 2d 25 (Tex. Ct. App. 1998).

The court stated "several Texas courts, addressing similar facts, have held that air-conditioning units are trade fixtures as a matter of law." Nevertheless, the court agreed with Henna that there "is no rule or presumption in Texas law that air conditioning units are always trade fixtures. The issue, rather, turns on the parties' intent, which here we ascertain from the lease."

Henna argued that Improvements for purpose of the lease included the HVAC units because these were described and depicted in the plans and specifications for Improvements that landlord approved pursuant to the terms of the lease. The plans and specifications included a drawing of a four unit 45 ton HVAC unit on the rooftop, similar to the one El Chico ultimately installed.

The court was not persuaded by Henna's arguments. The court read the language of the lease (against the drafter) very carefully. According to the court, paragraph 5 of the lease – detailing construction of the Improvements – "does not purport to incorporate into the lease's "Improvements" whatever property might have been depicted in the plans and specifications." Rather, this provision only required that the Improvements would be constructed "in conformity" to the plans and specifications."

Henna pointed out also that the lease specifically described El Chico's use as "the operation of a restaurant . . . and for any other lawful purpose." Taken together, Henna argued that Improvements under the lease included HVAC, and that given the stated use, this must have been both parties' intent.

Henna attempted to distinguish prior Texas case law. Those cases held that HVAC units were fixtures, but involved instances in which tenants installed units in pre-existing buildings; El Chico constructed the building on which it then installed rooftop units. The court considered this a distinction without a difference: "The critical issue, rather, is whether the parties intended the air conditioning units to be permanent additions to the building, or temporary additions to aid the tenant, El Chico, while it was operating a restaurant in the building." The court held that the latter was true.

As a last ditch argument, Henna asserted that, when it purchased El Chico's fixtures, the bill of sale did not list the HVAC units. The court dismissed this argument quickly, pointing out a catch all phrase in the bill of sale covering "all furniture, fixtures and equipment." More importantly, the court stated that the intent the parties at the time they executed the ground lease is what matters – not what the parties may or may not have said in the bill of sale. This intent and not the bill of sale define the meaning of "Improvements" and of "fixtures."

Reporters Comment 1: Friedman on Leases '24.3 explains that trade fixtures are typically removable by the tenant. The ability to remove fixtures is a departure from the early common law that prohibited tenant from removing anything attached to the land. Friedman also confirms the court's statement in El Chico that "a clear intent that installations belong to the landlord or tenant is controlling." §24.5. The treatise suggests that air conditioning units fall within the definition of trade fixtures, except to the degree that stipulations in the lease declare otherwise. "The common law of fixtures, as between landlord and tenant, often descends to an academic exercise in the face of stipulations. . . . The specific items involved by these stipulations may, among other things, include air conditioning, heating and refrigerating installations. . . ." §24.6. The court's recitation of the common law seems on solid ground.

Reporter's Comment 2: The landlord could obviously have done a much better job of describing what was included in Improvements and not in fixtures. The property was in the exclusive possession of El Chico and the landlord was not in a position to evaluate whether the HVAC was well maintained. There is always the possibility that tenant will default on the lease and only after it is evicted or vacates will landlord discover problems in the property. The landlord could have better protected itself.

Reporter's Comment 3: The lease did require landlord's approval for plans and specifications of the Improvements, which approval was given. The court says that this means only that the HVAC units had to conform to the plans and specs, and not that the HVAC (as described) became part of

the Improvements. The court is drawing a fine line between what "conforms" and what is incorporated. This distinction probably frustrated the landlord most of all, and is the most interesting aspect of the opinion.

The Reporter for this item was Daniel Bogart of the Chapman Law School.

LANDLORD/TENANT; LANDLORD LIABILITY FOR INJURY TO TENANT: Landlord did not violate statutory duty of care owed to tenant who was scalded in bathtub where tenant had lived on property for 4 years without any problems with water temperature and nothing had happened to change the temperature settings. ***Sabolik v. HGG Chestnut Lake Ltd. Partnership, 906 N.E.2d 488 (Ohio App. 8 Dist).***

Tenant was scalded by hot water, apparently after suffering a seizure in bath tub, and filed a negligence action against the landlord and contractor that installed the energy-saving hot water system. The Court of Common Pleas awarded summary judgment to landlord and contractor. Tenant alleged that the landlord failed to regulate the temperature of water flowing into his bathroom and that the contractor failed to activate software that would provide scald protection and further failed to activate a warning alarm to alert when water temperature exceeded programmed parameters. Tenant argued that the landlord had a duty to install a mixing valve on the hot-water heater to ensure that the water temperature did not rise above 120 degrees which is the industry standard.

Tenant lived in the complex for 4 years without any problems with the temperature of the hot water. To establish actionable negligence, the tenant must show the existence of a duty, a breach of that duty and an injury resulting proximately therefrom. The existence of a duty depends on the foreseeability of the injury. The landlord's statutory duty is set forth in general in R.C. Chapter 5321 which states that a landlord has a duty to maintain in good and safe working condition all electrical, plumbing, sanitary, heating, ventilating, and air conditioning fixtures and appliances, and elevators, supplied or required to be supplied by him. Violations of this statute are considered negligence *per se* which is not strict liability and requires the plaintiff to bear the burden of proving a breach of the statutory standard of care. The court cited *Sikora v. Wenzel*, 727 N.E.2d 1277 by stating "[A] landlord will be excused from liability [for a statutory violation] if he neither knew nor should have known of the factual circumstances that caused the violation." There was no evidence of any kind to show that the water temperature had been an issue for any of the occupants of the 121 apartment units. The tenant caused the increase in the hot water and landlord bore no responsibility for the injuries caused by his actions due to the seizure he experienced while in the bathtub. The Court held that, the landlord did not violate the statutory standard of care owed to tenant; landlord's failure to install a tempering/mixing device and monitor hot water temperature were not the proximate cause of tenant's injuries; contractor's failure to program the energy- saving system to limit the maximum temperature of water and sound an alarm did not cause tenant's injuries and contractor had no duty to program the system to sound an alarm.

LANDLORD/TENANT; PURCHASE OPTIONS; RIGHTS OF REFUSAL: Where a right of first refusal in a lease does not guarantee the landlord-seller a particular net recovery and does not require a tenant to pay the brokers' commission, a tenant is only required to match the gross sales price in the third-party offer and the landlord is obligated to pay whatever brokerage commissions are set out in the lease. ***St. George's Dragons, L.P. v. Newport Real Estate Group, L.L.C., 407 N.J. Super. 464, 971 A.2d 1087 (App. Div. 2009).***

A landlord and tenant signed a lease with a right of first refusal. The right of first refusal required the landlord to notify the tenant if it received a bona fide third party offer to purchase the property, at which time its tenant was afforded thirty days from the receipt of the offer to elect to buy the property for the purchase price listed in the offer. The landlord received an offer and forwarded it to the tenant. The tenant sent notice exercising its option.

The landlord then sent a letter to the tenant confirming that the tenant had agreed to match the net sales price to be received by the landlord from the third-party offer. The tenant did not agree with the calculation. The discrepancy was based on the difference between the commission structure contained in the lease and the third-party contract. The lease contained a provision that afforded the leasing broker a commission if the tenant purchased the property, and provided for sharing the commission with a cooperating broker. The contract with the third party, however, provided for a reduced commission and would not have shared the commission with another broker.

The landlord argued that in order for the tenant to match the third-party offer, the landlord had to receive the same net proceeds from the tenant as it would have received from a third party. Since the third party contract contained a lower commission, and thus a higher net for the landlord, the landlord argued that the tenant was required to pay a higher overall price so that the landlord received the same net proceeds under either deal.

The tenant argued that it was only required to match the gross sales price contained in the offer, and not the net sales price. It argued that pursuant to its lease it was not obligated to pay a commission to the brokers if it bought the building and that such a clause had been eliminated from the final draft of the lease at the tenant's insistence. Therefore, it was the landlord that was obligated to pay any commissions and the tenant's only obligation was to match the gross sales price contained in the third-party offer.

The lower court agreed with the tenant. It found that the tenant had properly exercised the right of first refusal and matched the gross purchase price contained in the third-party offer. It found that the landlord's supplemental letter regarding the net sales price had no bearing on the enforceability and effectiveness of the right of first refusal. The lower court also found that the landlord was obligated, pursuant to the lease, to pay commissions to the brokers as provided for in the lease.

On further appeal, the Appellate Division affirmed, finding that the right of first refusal provision in the lease and the contract did not guarantee the landlord-seller a particular net recovery and did not require the tenant to pay the brokers' commission. The tenant was only required to pay the purchase price in the offer, and the landlord was obligated to pay the brokers' commission set out in the lease.

The Court noted that the third-party offer could have been structured to require that the landlord receive a certain net sale proceeds, however, the contract would have to contain clear and unambiguous language to that effect. In addition, the right of first refusal provision in the lease needed to expressly state that the tenant, in exercising its right of first refusal, could be obligated to pay a price higher than the gross purchase price set forth in the offer. Since neither the contract nor the lease contained those provisions, the tenant, in exercising its right of first refusal, was only obligated to match the gross sales price in the third-party contract. Further, neither the contract nor the lease required the purchaser to pay the brokers' commissions so the landlord, as seller, was required to pay the commissions, which in this case was the higher commission set forth in the lease, as opposed to the commission required by the third-party contract.

Reporter's Comment 1: What can be said? Here's another opportunity lost for clear and precise drafting. An early draft of the lease called for the tenant-buyer to pay the brokerage commission. When it was removed in negotiation, no provision requiring the seller to pay the commission replaced it. In New Jersey, prevailing practice is that landlords and sellers pay the brokerage commission.

Reporter's Comment 2: Did the landlord or its attorney look at the lease before accepting the bona fide offer? Even if the lease had not contemplated this situation, the offer could have been crafted to compensate.

Reporter's Comment 3: How about the brokerage agreement for the lease? Was it negotiated or just signed as presented? Perhaps this case suggests that lease brokerage commission agreements that call for a commission at all if the tenant exercises a purchase option should contemplate paying the commission set forth in the bona fide offer.

Reporter's Comment 4: Though not important for the right of first refusal principles explicated by this decision, it should be noted that the sale to the tenant fell apart (before specific performance was ordered) because of a fight between competing brokers over splitting the commission.

Reporter's Comment 5: For those that wonder, the landlord did argue that its tenant had to pay the commission to the broker who had handled the lease in the first place even though the lease did not say so. Its argument was that the tenant was obligated to buy the property on the same terms and conditions as the offer. The offer was in the form of a purchase contract wherein the leasing broker was not named at all and the buyer agreed to indemnify the seller against claims by brokers, with whom the buyer dealt, if those brokers were not named in the contract. The landlord claimed that when its tenant stepped into the shoes of the offerer, it had to honor that agreement by indemnifying the landlord for the leasing broker's claim because the leasing broker had not been named in the proposed contract. Aside from

brushing this aside on grounds of ambiguity, the court said that if this was intended by the landlord to be a "poison pill" for the tenant, following that path would be a breach of the covenant of good faith and fair dealing, a vibrant covenant in New Jersey.

The Reporter for this item was Ira Meislik of New Jersey.

LANDLORD/TENANT; RESIDENTIAL; RETALIATORY EVICTION: Retaliatory eviction doctrine does not prevent landlord from terminating lease because tenant brought action to recover damages for personal injury. ***Helfrich v. Valdez Motel Corp., 207 P.3d 552 (Alaska 2009).***

A motel employee rented a room at the Pipeline Inn where he worked on a month-to-month basis. After work one day he slipped and fell on the property, breaking his leg. Tenant remained living and working on the premises on a part time basis. The tenant attempted to negotiate a settlement whereby the motel would pay the tenant's medical expenses. Then the motel terminated his employment and sent him a letter terminating the tenancy.

The tenant sued, asserting negligence and retaliatory eviction under the Uniform Residential Landlord and Tenant Act (URLTA). The URLTA prohibits a landlord from retaliating against a tenant "by increasing rent or decreasing services or by bringing or threatening to bring an action for possession after the tenant has...sought to enforce rights and remedies granted the tenant" under the URLTA. Alaska Stat. §34.03.310(a).

The trial court granted a directed verdict for the motel on the retaliatory eviction claim, and the landlord prevailed with a jury verdict on the negligence claim.

The Supreme Court affirmed, reasoning that the tenant's right to seek damages for personal injury was not granted by the URLTA, but arose under tort law. Two justices dissented, focusing on the URLTA requirement that the landlord "keep all common areas of the premises in a clean and safe condition." For reasons of public policy, they argued, tenants should not risk losing their home if they seek compensation because of injuries caused by unsafe conditions on the premises.

Reporter's Comment: Some language in the majority opinion suggests that the tenant could have prevailed if his attorney had framed the issue in terms of habitability and common area maintenance, rather than only in the vocabulary of tort law.

This item is reprinted (as edited) from *Probate & Property*, September/October 2009, Vol. 23 No. 5, published by the Real Property, Trust and Estate Law Section of the American Bar Association. The Reporter was Professor Jim Smith of the University of Georgia Law School.

LENDER LIABILITY; ENVIRONMENTAL LAW: Mortgagee not liable when mortgagee fails to pass on to borrower environmental report that lender deems to be satisfactory in making loan, but may have provided clues that borrower could have pursued in identifying contamination. ***Robert Hull and Point Pleasant Landco v. William Lewis (No.A-005403-07T3, App. Div.6/11/09).***

First Fidelity had issued a loan commitment to the plaintiff in 1993 that required receipt of an acceptable phase 1. The property had been a coin-operated laundry. The bank obtained a phase 1 that concluded that there were no obvious signs of contamination and that due to relatively small amount of dry cleaning performed at site, it was unlikely that PCE was stored in sufficient quantities or USTs to be identified as a REC. The Phase 1 report contained express language that it was for the exclusive benefit of the bank and "was not intended to be, nor should be, for the benefit of any third party, including without limitation, any owner or lessee of the Property."

After reviewing the phase 1, the bank told borrower that phase 1 results were satisfactory to meet the loan commitment but did not provide the borrower with a copy of the report. The borrower then proceeded to purchase. In 2002, borrower tried to sell the land. A prospective purchaser performed a phase 2 and discovered extensive PCE and declined to proceed with the purchase.

The borrower, now a plaintiff, filed a lawsuit against the prior owners and operators of the property was well as the bank and the consultant. The borrower/plaintiff alleged that it had relied on the bank's statement that the phase 1 was satisfactory to mean that the site was clean in proceeding to close on the property, and that the bank had a duty to advise the borrower of the specific findings of the phase 1 results and that failure was a breach of

contract. Plaintiff sought reimbursement of its remediation costs.

In a ruling from the bench, the trial court granted summary judgment to the bank on grounds that there was no evidence that plaintiff had relied on the bank's satisfaction with the phase 1 report in deciding whether to purchase the property, and if it had such reliance would not have been reasonable. The court said that any "green light" by the bank might just as well been a waiver of its own requirements. The court also noted that the plaintiff's 30 day contingency period had expired two months prior to the issuance of the phase 1 report.

The appeals court affirmed, holding the issue is not whether the Bank subjectively intended the approval of the loan as an assurance that the property was free from environmental degradation, but whether the plaintiffs actually relied on this representation and whether such reliance was reasonable. The court agreed with the trial court that there was no evidence that the plaintiff had reasonably relied on the phase 1 report.

Reporter's Comment 1: This case illustrates the importance of a purchaser performing its own due diligence even if this means reviewing the phase 1 performed on behalf of the bank. A lender does not stand in the same shoes as a potential owner of property because of the secured creditor exemption. So long as a lender does not become involved in the operations of its borrower or take title through foreclosure, its liability for environmental conditions will be limited to the value of the loan. When banks held loans on their balance sheets, this potential loss was often enough to incentivize lenders to perform thorough phase 1 reports. In the era of securitization, however, when the lenders would sell their loans almost immediately, lenders have been more concerned with keeping the assembly line of loan originations moving as fast as possible to maximize their fees.

The borrower, on the other hand, is going to be the owner of the property and will be first in line for any enforcement actions that may result if the land turns out to be contaminated. If the borrower is not named on the phase 1 report, it is quite likely that it will not be deemed to have engaged in an all appropriate inquiry or whatever level of due diligence may be required under a state innocent or prospective purchaser defense.

The preamble to the EPA AAI rule did state that "all appropriate inquiries investigations may be conducted by or for one person and used by another party." But relying on a report prepared for another party may not be considered to be conducting an all appropriate inquiry under state law.

Reporter's Comment 2: Many states have statutes that require owners of property to disclose existence of contamination to prospective purchasers. Lender liability statutes in those states generally to not provide protection for common law claims or for failing to comply with the disclosure requirements. Lenders should carefully review the provisions of state lender liability laws and the scope of environmental disclosure laws as part of their loan due diligence. For example, in 2007. the Supreme Court of Missouri in *Hess v. Chase Manhattan Bank* (220 S.W.3d 758; 2007 Mo. LEXIS 65, 5/1/07) upheld a jury verdict finding a bank liable for common law fraud for failing to disclose the existence of an EPA investigation in a foreclosure sale. In so holding, the Court said that disclaimers in the contract did not preclude the fraud claim.

[The Bank had an obligation to disclose material information that was not discoverable through ordinary diligence and that the plaintiff could not have reasonably discovered the existence of EPA's investigation in the kind of diligence ordinarily done for real estate transactions of this kind. The bank also had failed to file the required property disclosure statement.]

Missouri had a statute compelling disclosure of any material information concerning property to be sold. But even if a state does not have a statutory disclosure law, there may be an obligation under common law to disclose the existence of contamination or the results of prior investigations. Lenders have been held liable for improper disclosure in the past under common law theories of misrepresentation. For example, For example, in 2004 a Rhode Island Superior Court jury ruled that Fleet Bank was liable for $5.14 million in damages for failing to inform purchasers of a general store that the property drinking water was contaminated (*Foote v. Fleet Financial Group*).

Another example was in 1999 when a Pennsylvania state court allowed a purchaser of contaminated land to maintain a claim for negligent misrepresentation against the bank when the bank failed to advise the plaintiff that

real estate appraisal did not address environmental conditions (*Seats v. Hoover,* 1999 U.S. Dist. LEXIS 13379, August 18, 1999).

In 1991, the Montana Supreme Court reversed a summary judgment ruling in favor of a bank and allowed the borrower to proceed with negligent misrepresentation and constructive fraud claims against its former lender because there was a question of material fact whether the bank had created a false impression about the environmental conditions of the property (*Mattingly v. First Bank of Lincoln,1997 WL 668215* (Sup. Ct. Montana, Oct. 28, 1997).

In *Boyle v. Boston Foundation, Inc*.,788 F. Supp. 627 (D. Mass. 1992) a bank that failed to disclose to purchasers of contaminated property the existence of notice from a state agency ordering a cleanup at the site was not held liable for misrepresentation because of a doctrine unique to the failed financial institutions taken over by the FDIC. The agency was acting as a receiver for the failed bank. The failure to disclose material information was held to constitute an "agreement" under the *D'Oench* doctrine and since this was an unwritten agreement, the plaintiffs could not prevail against the FDIC. It is likely that the plaintiff would have prevailed had the bank not been in receivership.

It seems that at least once a year there is a case imposing liability on a bank for inadequately disclosing environmental conditions of foreclosed property that it has sold. It is not only prudent to err on the side of full disclosure in transactions, but in emerging areas such as vapor intrusion, to look back at prior disclosures to see if they could form the basis of a claim for non-disclosure. Given the volume of foreclosures we are now seeing, I would not be surprised to see more of these cases during the next year or so.

The Reporter for this item was Larry Schnapf of the New York Bar.

LENDER LIABILITY; WAIVER OF CLAIMS: Agreement to renegotiate a debt that was a factor in alleged misapplication of setoff rights by a lender constitutes a waiver of claims against the lender for such misbehavior. ***Holland v. Peoples Bank & Trust Co., 3 So. 3d 94 (Miss. 2008).***

Holland was the borrower on several loans from Peoples Bank and Trust Company. Holland also attempted to set up at Section 1031 exchange from the sale of other land with the bank as the qualified intermediary. The bank received the proceeds from the sale of the land and applied them to a loan owed by Holland to the bank. The bank claimed that the agreement for the Section 1031 exchange had never been completed and that the sale proceeds were never deposited in an escrow account.

Holland, who was represented by counsel, subsequently entered into a workout agreement regarding the loans and signed an amended promissory note renewing the loan.

Holland then brought an action against the bank alleging, among other things, that the bank misapplied the proceeds from the sale of the land and thereby breached a fiduciary duty to Holland. Holland also alleged negligent misrepresentation and fraudulent misrepresentation. The bank argued that any possible claims that Holland had against the bank were waived when Holland entered into the workout agreement and signed the renewal notes. Holland argued that the workout agreement and renewal notes only pertained to the loans and were not related to the alleged misapplication of the proceeds from the sale.

The trial court granted the bank's motion for summary judgment on this issue. On appeal the Mississippi Supreme Court, in a decision by Justice Carlson, affirmed. By executing the workout agreement and renewal note, Holland waived all possible claims that he had against the bank.

Reporter's Comment 1: The court relied on *Austin Development Company, Inc. v. Bank of Meridian*, 569 So. 2d 1209 (Miss. 1990). In the Austin Development case the bank held a letter of credit as collateral for its loan and failed to make a timely demand for payment on the letter. As a result the borrower went into default and had to sign a renewal note. When the borrower brought an action against the bank for negligence in failing to make demand on the letter of credit, the court held that by signing the note, the borrower waived his negligence claim against the bank. In the Austin Development case, the negligence claim arose out of roughly the same set of facts. In the Holland case, the claims that the court held were waived arose of out what appears to the editor to be a separate transaction. The Holland case therefore arguably is an expansion of the waiver doctrine applied in Austin Development.

Reporter's Comment 2: It is interesting to the Reporter that the fact that the borrower executed a renewal note seems sufficient to the courts in both the *Austin Development* and *Holland* cases to waive the other claims, without the necessity that the note or workout agreement reference the other claims. In *Austin Development* there was only a note and not a workout agreement. In *Holland* the borrower signed a workout agreement as well as a note, but the court did not quote from the workout agreement or make reference to any of its terms. In neither case did the court scrutinize the wording of the relevant documents, but found that the fact that a renewal note had been signed sufficient without any express waivers. Most of the workout agreements that the Reporter sees contain pages and pages of detailed waivers. Are these detailed waivers really necessary, and do they potentially create a risk that if we try to cover every circumstance, we risk missing one?

Comment 3: In *Austin Development* the borrower was an experienced commercial developer. In *Holland* the borrower was a cotton broker and commodities trader who was represented by counsel. Would a court apply this waiver doctrine as strictly if the borrower was an unsophisticated consumer? The author of the *Austin Development* decision, Justice Roy Noble Lee, noted in that opinion that he had dissented in an earlier case applying this waiver doctrine because the borrower was "an unsophisticated woman who had been defrauded by her husband, and she signed a promissory note initially based upon a representation of the Bank, which turned out to be false." 569 So. 2d at 1212 n. 2.

The Reporter for this item was Rod Clement of the Mississippi bar, writing in the July, 2008 issue of the Newsletter of the Real Property Section of the Mississippi Bar. Reprinted with permission.

MORTGAGES; ASSIGNMENTS OF RENTS; CONSTRUCTIVE EVICTION: Tenant may assert constructive eviction claim against landlord's mortgagee, rents assignee, based upon defects caused by assignor landlord notwithstanding UCC 9-4039(c), tenant's estoppel certificate or "hell or high water" clause in the recognition agreement. ***Reliastar Life Insurance Company of New York v. Home Depot U.S.A., Inc., 570 F.3d 513 (2d Cir. 2009)***, discussed ubnder the heading: "Landlord/Tenant; Constructive Eviction; Waiver."

MORTGAGES; "BAD BOY" CLAUSES: Once a Non-Recourse Carve-Out is triggered, it doesn't matter that is cured or that its occurrence in the first place had no effect on the lender; the borrower and each guarantor otherwise protected from liability for the borrowed amount become liable for the entire outstanding loan; and the amount thus collectable will not be characterized as liquidated damages. ***CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, A-6307-07T2, 2009 WL 2431530. (N.J. Super. App. Div. 2009); August 11, 2009***, discussed under the heading: "Mortgages; Guaranties; Carve-outs; Liquidated Damages."

MORTGAGES; DEFICIENCY JUDGMENTS; ANTI-DEFICIENCY STATUTES: Multiple notes and mortgages covering same property are deemed "inextricably intertwined," and foreclosure of senior secured note eliminates any claim on the second secured note as well, even if second note was entered into for a new loan (from the same lender) at a later date than the first. ***Iwan Renovations, Inc. v. North Atlanta National Bank, 673 S.E. 2d 632 (Ga. Ct. App. 2009).***

Iwan obtained a $338,000 loan from North Atlanta National Bank ("Bank") in May of 2005 for the purpose of buying real property and building a home on it. Iwan executed both a note and a deed to secure debt (which is the Georgia mortgage form that permits non judicial foreclosure.) The initial loan amount was skimpy: on two separate occasions Bank agreed to modify the terms of the loan. The first modification increased the balance of the loan to $360,150 and extended the maturity date of the note, and the second modification extended the maturity date even further.

Apparently, Iwan asked for additional funds to accompany the second extended maturity date. However, the Bank's internal guidelines prohibited it from providing additional funds and modifying the terms of the original note once more as it had previously done for Iwan. The Bank was willing to give Iwan an additional $25,000 in loan money, but it required Iwan to sign a new note and secure the note with a new deed to secure debt. The deed to secure debt covered the same property described in the first deed to secure debt. The various notes and deeds to secure debt contained cross default clauses. The second loan was consummated on December 19, 2005, seven months after execution of the original note and deed to secure debt.

Although the opinion does note relate the details, it is clear that things did not go well for Iwan. On June 26, 2006, Iwan asked the Bank to once again extend the date for maturity of the debt – that is, to extend the maturity date to both promissory notes. The Bank agreed, but this time it asked for a personal guarantee of Dave Iwan ("Dave") of the second note (which, as you recall, was in the principal amount of $25,000.) Iwan and Dave agreed and Dave became a guarantor of the additional loan money.

Obviously, the next step was Iwan's default. The Bank demanded payment on both promissory notes as well as attorney's fees permitted under Georgia statute if forced to file suit for recovery of the debt. Two weeks after sending its demand letter, the Bank filed suit against Iwan and Dave to recover amounts owed under both the notes, as well as fees to collect.

With its lawsuit already underway, the Bank then proceeded to foreclose non judicially the first deed to secure debt, secured by the $360,150 promissory note. The Bank purchased the property at the foreclosure sale for $398,322.15. The Bank did not seek a deficiency judgment from Iwan and did not take the step of confirming the sale price.

The original lawsuit sought payment on both promissory notes. However, foreclosure of the first deed to secure debt eliminated the debt under the first note. Bank therefore amended its complaint to state that it would seek only recovery of the money owed on the second note, plus expenses. Iwan responded that the Bank's attempt to collect on the second note was nothing more than a disguised deficiency judgment. The trial court granted summary judgment to the Bank; the Court of Appeals reversed.

Georgia Code '44-14-161(a) bars parties foreclosing on property pursuant to powers of sale from obtaining a deficiency judgment unless "the person instituting the foreclosure proceedings shall, within 30 days after the sale, report the sale to the judge of the superior court of the county in which the land is located for confirmation and approval and shall obtain an order of confirmation and approval thereon."

The confirmation proceeding is meant to allow the judge to determine whether the property was sold for less than market value and whether any of the technicalities of foreclosure (time and manner of sale) were violated.

In the usual course, when a lender makes a loan evidenced by a note and secured by a mortgage, the lender is not required to pursue the collateral and may choose instead simply to enforce the contractual obligation for payment of the note. The problem is that this can create an incentive for lenders to creatively paper deals to avoid judicial confirmation proceedings that might have the effect of depriving the lender of deficiency judgments.

Quoting *Oakvale Road Assoc. v. Mtg. Recovery Fund*, 499 S.E. 2d 404 (1998), the opinion states "As a general rule, two debts that are incurred for the same purpose, secured by the same property, held by the same creditor, and owed by the same debtor are inextricably intertwined." If the debts are inextricably intertwined, then the court will treat the debts as one for the purposes of the confirmation requirement.

In this case, the Bank essentially argued that the second note and deed to secure debt represented a separate loan and therefore it had every right to enforce the promissory note. The Bank relied on prior Georgia cases, including *Devin Lamplighter, Ltd. v. American Gen. Finance*, 426 S.E.2d 645 (1992). In that case, a junior creditor purchased a senior's debt and foreclosed without obtaining confirmation, then proceeded to sue on the junior note. The court was unimpressed, saying that *Devin* "involved separate debts, evidenced by separate notes, made initially to different creditors at different times, and for different purposes." In other words, the debts were not intertwined for the purposes of confirmation of sale.

The debts in *Iwan Renovations* were incurred seven months apart, but the court viewed this as of no consequence. Furthermore, the court suggested that the cross default provision indicated the Bank viewed the debts as part of a single loan arrangement. As a result, the Bank's attempt to proceed on the second note after foreclosure of an intertwined first mortgage was barred.

Reporter's Comment 1: The Bank's internal guidelines were not much help to it. The guidelines certainly did not limit the Bank from loaning more money to Iwan. Perhaps the Bank had a policy of splitting loans in this

manner because of the hope that it could pursue a deficiency in a manner proscribed by the court in the opinion. Iwan asked for an extended maturity date, and it would have been entirely fair for the Bank to ask for new security – additional property secured by a new deed to secure debt and evidenced by a new loan. The Bank did not take new collateral; instead it obtained a new note and a new mortgage over the old property, as well as a personal guarantee.

Reporter's Comment 2: The court focuses on the fact that the debts were only seven months apart; it uses this fact (among others) to determine that the debts were inextricably intertwined. Seven months may seem fairly close together in time to the court, but that is still more than half a year. What if Iwan had requested an extended maturity date a year after the first debt? What if the request came 18 months afterwards? What (if any) time period would have suggested to the court that the debts were not intertwined?

Reporter's Comment 3: The different jurisdictions vary in the kinds of statutes employed to deal with lender's right to obtain a deficiency judgment, but in every state lenders are tempted to work around the rules. California employs a robust one action rule, but casebooks are filled with lender attempts to take that second bite.

The Reporter for this case was Professor Daniel Bogart of the Chapman Law School.

MORTGAGES; EXTENSIONS AND RENEWALS: A refinancing loan in the same amount of the original loan, but from a third party, is not an "extension or renewal" for purposes of a subordination agreement affecting the original loan, but the refinancing lender may qualify for equitable subrogation. ***UPS Capital Business Credit v. Abbey, 2009 WL 2046157 (N.J. Super. Ch. Div. 2009); June 26, 2009.*** Discussed under the heading: "Mortgages; Subrogation."

MORTGAGES; FORECLOSURE; NOTICE; MERS: MERS, identified as nominee of the lender in the mortgage documents, and recorded as mortgagee in the land records, is not entitled to intervene in a confirmation proceeding when a senior mortgagee judicially forecloses and serves notice only upon the originating lender. ***Landmark National Bank v. Kesler, ___ P. 3d ___, 2009 Westlaw 2633640 (Kan. 8/28/09).***

The Supreme Court ruled only that MERS and the current holder of the note, for which MERS stood as nominee, were barred from intervening in a proceeding to confirm the sheriff's sale and distribution from a foreclosure of a mortgage prior to the MERS recorded mortgage when neither party had been named as a party to such foreclosure. But the court essentially was held that neither had the right to receive notice of the foreclosure to begin with. This is not surprising with respect to the current holder of the note, Sovereign, because Sovereign had not recorded it assignment of mortgage from the originator, relying on the MERS recording as nominee. But holding that a recorded nominee of the holder was not entitled to notice is quite significant and disturbing.

The case has nothing to do directly with the right of MERS to transfer rights in the debt or to foreclose the debt, but there is plenty of language in the case that puts those rights into question, and indeed the court cites with approval cases that have questioned those other functions of MERS.

The statutory standard for whether a party is a "contingently necessary party" to a foreclosure proceeding if: . . . "he claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action in his absence may (I) as a practical matter substantially impair or impede his ability to protect that interes. . . .

Needless to say, this standard would apply to the holder of a junior lienholder in a proceeding to foreclose a senior lien. But the court found that MERS was not a junior lienholder, even though the record so indicated, and in fact did not have "an interest relating to the property" that was the subject of the mortgage.

The court accepted the description of the secondary market system of which MERS is a part as being one in which "lenders retain the notes as well as the servicing rights to the mortgage" But "lenders can then sell these interest to investors without having to record the transaction in the public record" because MERS is listed as the mortgagee of record through assignment of the members' interest to MERS and recordation of MERS in the public records.

The mortgage in this case identified MERS as the nominee of the Lender and Lender's successors and

assigns, but it defined the originating lender, Millenia, as the "Lender" under the documents. The mortgage provided that MERS, as nominee, had the right to exercise any and all of the interests granted in the mortgage, including, but not limited to, the right to foreclose and sell the Property, and to take any action required of Lender, including, but not limited to, releasing or cancelling this mortgage."

Other places in the mortgage identified the Lender as having certain rights, including, most notably, a notice provision that indicated that notices under the mortgage should be provided to "the Lender." Another notice provision stated that notices of default and foreclosure under prior instruments should be provided to Lender. The court emphasized this language, but it should be noted that Kansas is a judicial foreclosure, so any notice provision in the instruments was not controlling as to notice of foreclosure.

The court made much of the fact that the mortgage instrument continued to identify Lender (identified as the originating lender) has having certain substantive rights despite the fact that MERS had the right to assert those rights as nominee.

After noting that the parties, at oral argument, and the lower court, citing Kansas authority, has given various meanings to the term "nominee," and analogizing to blind men and elephants, the court stated that "the legal status of a nominee, then, depends on the context of the relationship of the nominee to its principal . . . The relationship that MERS has to Sovereign [the note holder] is more akin to that of a straw man than to a party possessing all the rights given to a buyer.

In justifying its conclusion, the court emphasizes that the original mortgage gave certain express rights to the "Lender" [even though it simultaneously gave MERS as nominee the right to exercise those rights.] Consequently, the court concluded that there was separation of the rights of the lender from the holder of the security instrument. In doing so, of course, the court appeared to ignore the fact that MERS had the right to exercise any and all rights of the Lender, the note holder.

The court cited to Nebraska authority in which MERS argued successfully that it need not be licensed as a lender because it did not in fact loan or collect money. It appeared to conclude that even though MERS technically had the rights of the lender or its assigns, it customarily did not exercise them and acted simply as a record keeper.

Consequently, since MERS had no tangible interest in the foreclosure proceeding, it was not entitled to notice of the foreclosure as a "contingently necessary party." Further, as it had no property interest, there was no denial of due process in failure to notify it of the foreclosure.

Comment: There is not much that MERS can take away from this case that will give cheer. One point to emphasize is that the court expressly did not hold that MERS was not entitled to notice and service in the original foreclosure, but only that it had no right to intervene to set aside a default judgment against it on the grounds that it had not received notice. Further, and perhaps even more significant, the court noted that MERS' principal, Sovereign, although not a recorded interest holder, did receive notice from the bankruptcy proceeding that the senior lender had received leave to foreclose. Thus, one might argue that MERS' interest group was aware of the pending foreclosure and that the requirement of service of process was a moot point. Finally, the court based its decision on the record in the trial court, and perhaps that record might have been better made. But we have to remember it was only a motion to intervene. MERS' counsel may have been saving a broader exposition of the issues for what it anticipated would be a substantive hearing.

But these are slender threads. This case, coupled with equally hostile holdings on other issues in Arkansas and Missouri, indicate that there has been a cold reception for MERS in the central Midwest. MERS did get better treatment in Minnesota, as reported earlier.

MORTGAGES; GUARANTIES; CARVE-OUTS; LIQUIDATED DAMAGES: Once a Non-Recourse Carve-Out is triggered, it doesn't matter that is cured or that its occurrence in the first place had no effect on the lender; the borrower and each guarantor otherwise protected from liability for the borrowed amount become liable for the entire outstanding loan; and the amount thus collectable will not be characterized as liquidated damages. ***CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, A-6307-07T2, 2009 WL 2431530. (N.J. Super. App. Div. 2009); August 11, 2009.***

The Appellate Division of the New Jersey Superior Court was asked "whether a non- recourse carve-out clause in a mortgage note, providing that [the borrowers] are personally liable to [the] lender for damages resulting from violation of a particular loan obligation, is a liquidated damages provision, and if so, whether it constitutes an unenforceable penalty." A $13,300,000 mortgage loan was secured by a guaranty of principal executed by the borrower's principals. Although the loan was a non-recourse obligation, and the lender could not seek recovery against the borrower or the guaranteeing principals in the event of default, the note "contained a carve-out clause, providing that the debt would be fully recourse if the borrower failed to obtain the lender's prior written consent to any subordinate financing encumbering the property." Under the guaranty agreement, the guaranteeing principals were liable to the same extent as would be the borrower under that provision.

During the term of the loan, the borrower obtained $400,000 in subordinate financing secured by a second mortgage on the property without first obtaining its first lender's consent. This triggered the non-recourse carve-out provision of the loan documents and made the loan fully recourse as to both the borrower and the guarantors. The $400,000 mortgage was satisfied seven months later, but was not discharged of record. Beginning eighteen months later, the borrower stopped making payments on its first mortgage loan. This triggered an uncontested foreclosure action.

The property was sold by the sheriff's sale, leaving a deficiency of slightly over $5,000,000. Based on the subordinate financing default, the lender sought to collect this deficiency from both the borrower and the guarantors. This was met with the argument that since the lender "was not harmed by the added encumbrance on the property, the breach was only related to any damages suffered by [the lender] and therefore the non- recourse carve-out clause extracted an unenforceable penalty." The lower court rejected this argument, "finding that the damages sought by [the lender] were neither speculative nor estimated, but actual, ('equal to the outstanding loan balance and nothing more') and fair, ('[t]he defendants hav[ing] received the benefit of their bargain by receiving and retaining the loan proceeds')."

The borrower and the two guaranteeing principals appealed, mainly arguing "that the non-recourse carve-out clause [was] unenforceable as a liquidated damages provision because the penalty extracted from the borrower's breach of a covenant not to further encumber the mortgaged property [bore] no reasonable relationship to any harm suffered by the lender." This argument failed on appeal. Rejecting the arguments raised by the borrower and its two principals, the Appellate Division first cited the well-settled principle that a court's function is to enforce contracts as written "and not to make a better contract for either of the parties." It found the non-course language to be plain and capable of legal construction, and no reason to avoid the clear meaning of that language. Further, it felt that the applicable provision was unambiguous.

The Appellate Division, and the lower court below, characterized this as a "commercial transaction negotiated between business entities with comparable bargaining power." It opined that the borrower and the guarantors knew and agreed to the carve-out provision and knew that it was a material term in acquiring the loan. On that basis, the Court held the obligated parties "to the plain and clear language they chose."

The Court held that this carve-out clause was "not a liquidated damages provision, much less an enforceable penalty. A clause is a liquidated damages provision if the actual damages from a breach are difficult to measure and the stipulated amount of damages is 'a reasonable forecast of the provable injury resulting from [the] breach.'" Driving to the heart of the matter, the Court further held that "[n]on-recourse carve-out clauses like the one here are not considered liquidated damages provisions because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages. Generally speaking, because non-recourse loans may create issues of a borrower's motivation to act in the best interest of the lender and the lender's collateral, 'lenders identified defaults that posed special risks and carved them out of the general nonrecourse provision'."

In other words, "the non-recourse nature of [such a] loan operates as an exemption, the carve-outs exist to implicate personal liability."

Another important reason behind the Court's decision was its belief that the carve-out clause provided only for actual damages. This differed substantially from the typical liquidated damages provision in that the amount

of damages is not fixed at the beginning of the loan, but reflect only the actual damages incurred by the lender.

Lastly, it didn't matter to the Court that the borrower "eventually cured the very breach that triggered" the personal liability and that "no harm accrued to [the lender] as a result thereof." Even though the encumbrance was only temporary, the borrower's action "had the potential to affect the viability and value of the collateral that secured the original loan." Further, the Court mused that it could not say with "any certainty that the subordinate financing in this case was entirely unrelated to [the] ultimate default." More formalistically, the Court opined that "the fact that such potential may not have actualized [did] not diminish the breach of obligation nor vitiate its contracted-for consequences."

Reporter's Comment 1: WOW, wasn't that a surprise. Let's assume the person negotiating the Non-Recourse provisions bargained intensely for a provision that the borrower and guarantors would only be liable to the extent the breach of the non- recourse provision resulted in a loss to the lender.

Reporter's Comment 2: The court spent a great deal of time rejecting claims made by the borrower and the guarantors that allowing the lender to collect the entire debt and not be limited to whatever sale of the property would realize would be an unenforceable penalty. The lender only agreed to waive its claims to collecting the deficiency if certain conditions were met. Those conditions were not met once the borrower availed itself of secondary financing. Thus, the borrower simply didn't qualify for the deficiency waiver.

Reporter's Comment 3: Did whoever undertook (or should have undertaken) to have the second mortgage satisfied of record realize the consequences of failing to do so. It is likely that the lender's foreclosure search would not have reported the mortgage had it been satisfied.

Reporter's Comment 4: According to the New Jersey court, while this was a matter of first impression in that state, courts in other states have uniformly held that non-recourse carve-out provisions are valid and enforceable. See: *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp 2d 366 (D. Mass. 2007); *First Nationwide Bank v. Brookhaven Realty Assocs.*, 223 A.D.2d 618 (N.Y. App. Div); *Prince George Corp*. 58 F.3d at 1041 (4th Cir. 1995).

Editor's Comment 1: The editor believes that the reporter was tongue in cheek with his "wow" in the first comment. These were big boys who signed clear waivers of non-recourse protections. The nature of the default, as the court points out, was such that a significant violation might endanger the health of the company, and therefore it's ability to repay the senior debt. But the default itself was insignificant and likely create such endangerment.

Editor's Comment 2: Although one may argue about the exact definition – the clause, at least as applied – was a "bad boy" clause, and we have a relatively clear court holding viewing such a clause as not a penalty and not subject to liquidated damages clauses. That's news.

The Reporter for this item was Ira Meislik of the New Jersey Bar.

MORTGAGES: PREPAYMENT: DRAFTING: Even though lender drafted prepayment provision in commercial mortgage note that did not reflect true intent of the parties, court would not void provision because, as written, premium would always be negative and deemed to be zero and lender would never collect a prepayment premium, therefore producing an "absurd" result. ***BKCAP, LLC v. Captec Franchise Trust* 2000-1, *572 F.3d 353 (7th Circuit 2009).***

In this case the Seventh Circuit (surprisingly) came to the aid of the lender, who had incorrectly drafted the prepayment provision contained in the mortgage note. According to the court, "This case demonstrates that even experienced, sophisticated business entities can encounter difficulty when drafting carefully negotiated loan documents." The court noted that the prepayment provision had been poorly drafted and the dispute between the parties as to the amount owing under the provision was approximately $800,000, "an amount worthy of the litigation effort expended here."

When the loan was being negotiated, the borrowers were unhappy with the lender's standard form of prepayment-premium provision. They wanted the right to prepay without penalty after the first ten years of the loan term. The lender agreed to this modification and redrafted the Note to define the prepayment premium as:

> "equal to the positive difference between the present value (computed at the Reinvestment Rate) of the stream of monthly payments of principal and interest under this Note from the date of the prepayment through the tenth (10th) anniversary of the First Full Payment Date at the Stated Rate . . . and the outstanding principal balance of this Note as of the date of the prepayment (the "Differential"). In the event the Differential is less than zero, the Prepayment Premium shall be deemed to be zero . . . ."

The court refused to adopt the plain-language reading of the revised prepayment- premium provision because doing so would, it reasoned, result in an absurd result, *i.e.*, even if the U.S. Treasury rate dropped significantly, the "stream of monthly payments" variable (calculated through the tenth year of the loan) would always be less than the premium as calculated under the second "outstanding principal balance" variable, thereby creating a prepayment premium that would always be negative and "deemed to be zero under the contract." The court stated that, "That was not the intent of the parties, who, as rational business entities, agree that the purpose of the Prepayment Premium is to provide some penalty in the event the borrowers prepay."

But the court refused to accept the lender's "solution" of including the balloon payment in order to produce a "Positive Prepayment Premium and avoid an absurd result," and also rejected the borrowers' "strict construction" argument, finding that the rule of construing ambiguities against the drafter does not give courts "a license to bypass relevant, extrinsic evidence in favor of simply declaring judgment for the non-drafter." The court found that the clause as written was ambiguous because it made no economic sense, and held that the interpretation of the language required extrinsic evidence. The court therefore remanded the case for a trial on the issue of the parties' intended meaning of the prepayment-premium provision.

Reporter's Comment 1: It is certainly unusual for a court to favor the lender (or at least give it a chance to avoid summary judgment) in connection with the enforceability of a prepayment premium when the clause is drafted by the lender and is admittedly ambiguous or incorrect based on the parties' actual intentions. *See, e.g., Sundance Apartments I, Inc. v. General Electric Capital Corp.*, 581 F.Supp. 2d 1215 (U.S.D.C. S.D. Florida 2008). In *Sundance*, the borrower, Sundance, brought an action against the lender (the trustee of a commercial mortgage-backed security trust created by the lender) and the servicer, claiming that the yield-maintenance prepayment provision in the loan agreement was "deceptive," forcing Sundance to make a prepayment (under protest) in excess of the actual premium due. The court agreed with Sundance's interpretation of the provision, upholding the borrower's claims of breach of contract and violation of the Florida Deceptive and Unfair Trade Practices Act as valid claims, and denying the lender's and servicer's motions to dismiss. The yield-maintenance provision in the Loan Agreement entered into between the parties read as follows:

As used herein, "Yield Maintenance Amount" means the sum of the present value on the date of prepayment of each Monthly Interest Shortfall (as hereinafter defined) for the remaining term of the Loan discounted at the Discount Rate.

The Monthly Interest Shortfall is calculated for each monthly payment date and is the product of (A) the prepaid principal balance of the Loan divided by 12, and (B) the positive result, if any, from (1) the yield derived from compounding semi-annually the Loan's Contract Rate minus (2) the Replacement Treasury Rate (as hereinafter defined).

The court summarized the parties' arguments as follows, based on the language in the above prepayment provision:

Sundance alleges that the term "prepaid principal balance" found in the [yield maintenance] Provision must be read to mean "the prepaid balance of the loan for each payment remaining in the term as amortized" in light of its plain meaning and industry custom. Defendants, however, rejected that interpretation and instead read the term to mean "a principal balance fixed at the time of prepayment," which allegedly generates a windfall (the "Windfall Interpretation") and permitted Defendants to recover a yield greater than they would have recovered if Sundance had made its regular payments through the maturity of the loan.

Id. at 1218.

The court ruled that the provision was deceptive and misleading because it "was intended to allow [the

lender], or its successor, to charge Sundance a repayment amount that allegedly exceeds the plain meaning and common understanding of the term 'yield maintenance.'" Id. at 1221. Sundance alleged that it had suffered "actual damages" when it paid the prepayment amount demanded by the lender under protest, and argued that its actual damages should be "calculated as the difference between the alleged correct yield maintenance prepayment amount and the Windfall Interpretation as well as costs, attorney's fees, and other relief." Id. at 1219.

Reporter's Comment 2: The *Sundance* and *BKCAP* cases, supra, clearly illustrate the importance of clarity and completeness when drafting yield-maintenance provisions in mortgage-loan documents. Although in most cases an ambiguity will be construed by a court in the borrower's favor when the lender has drafted the loan documents, the *BKCAP* case, *supra*, indicates that this rule may not apply when it would result in an "absurd" economic result. As the court cogently noted in *BKCAP*, "while disputes over the meaning in loan documents can be somewhat dry, this one is more interesting than most such cases." But it would not be wise to rely on such a holding when drafting prepayment provisions in loan documents. If the lender's counsel is not absolutely certain that the prepayment provision as drafted reflects the parties' actual intent, the language should be reviewed by a business person familiar with calculating enforceable yield-maintenance prepayment premiums.

Reporter's Comment 3: In another significant ruling on the meaning of the language contained in a prepayment-premium provision negotiated by the parties and drafted by the lender, the Illinois Appellate Court (First Judicial District), in *LaSalle Nat'l Bank v. Metropolitan Life Insurance Co.*, Nos. 1-00-4074 and 1-01-1255 (cons., Nov. 26, 2002), issued a 23-page Order upholding the Cook County Circuit's Court ruling in favor of the borrower's interpretation of a prepayment-premium provision. In a 112-page opinion, the Circuit Court ruled in favor of Merchandise Mart Owners, L.L.C., and awarded Mart Owners the entire $53 million held in escrow with the court. This amount constituted the disputed prepayment fee of $47 million, and the interest accrued thereon till the date of the ruling, claimed by Metropolitan Life Insurance Company as the result of the sale of the mortgaged Chicago commercial property, the Merchandise Mart ("Mart"), to Vornado Real Estate Investment Trust ("Vornado") for $625 million in 1998 (prior to the end of the loan term). This ruling came after a lengthy bench trial that generated more than 5,700 pages of testimony. The dispute arose out of the language in the prepayment provision in MetLife's 1987 20-year nonrecourse loan to Mart Owners in the amount of $250 million, which was secured by a first mortgage on the Mart. The prepayment clause in the mortgage was highly unusual. The provision contained "lockout" language that prevented any prepayment during the first 10 years of the loan. The mortgage could be prepaid during the last 10 years, but a "prepayment fee" would be due and payable by the mortgagor equal to the excess, if any, that would be required (over and above the outstanding principal balance) to purchase, on the date of prepayment, a "security instrument selected in good faith" by MetLife that, in the "good faith judgment" of MetLife, was of "comparable investment quality" to the original 1987 loan as of the date the loan was made.

The trial court acknowledged that "It is clear from the testimony and court documents, and the language in the body of the opinion, that Mart Owners clearly always expected to pay a prepayment premium of some undetermined amount." But the trial court also stated that "MetLife [the lender] knew or had reason to know that Mart Owners attached that meaning [suggested by Mart Owners] to the provision, and Mart Owners did not know or have reason to know that MetLife attached a different meaning to the provision. Accordingly ... the provision has the meaning attached by Mart Owners."

The appellate court agreed with the reasoning of the trial court, and stated that "[t]he Loan contained a prepayment premium which was unique to MetLife and the product of extensive negotiations between the parties." (The appellate court also apparently agreed with Judge Reid, who stated in his circuit court opinion that, "The language of the prepayment penalty provision at issue in this case is unique. The evidence at trial failed to reveal any other loan with a prepayment penalty provision similar to the one at issue in this case"). The appellate court also found that the testimony showed that the individuals who analyzed this provision internally at MetLife were aware of these facts, as well as the requirement that "the comparable instrument selected had to be available for purchase on the date of prepayment but did not actually have to be purchased."

a. The appellate court concurred with the circuit court's finding that "the prepayment provision

was clear and unambiguous," and rejected MetLife's claim that the circuit court had unfairly shifted the burden of proof on to MetLife to demonstrate its compliance with the prepayment provision instead of requiring Mart Owners to prove that MetLife had breached the provision.

b. Making reference to the three separate factors that the circuit court found were determinative as to whether MetLife had breached the prepayment provision, the appellate court found that it was "necessary to address only one of the court's findings, specifically its conclusion that MetLife materially breached the loan agreement by failing to select a comparable security instrument that was available for 'purchase' by MetLife."

c. The appellate court found that the evidence presented at trial clearly established that instead of selecting an actual "security instrument" that was "available for purchase" by MetLife, it selected an index of A-rated corporate bonds that (as acknowledged by MetLife's own experts) was not available for purchase. According to the court, "MetLife's asserted good faith in the selection of the bond index does not alter the clear fact that MetLife did not comply with the express terms of the prepayment provision and, thus, cannot excuse its breach." The court further stated that it would "decline MetLife's invitation to take judicial notice of MetLife's purported ability to buy the index upon which it relied," and rejected MetLife's claim that Mart Partners had unfairly changed its position to MetLife's detriment during the course of the litigation. The court also concurred with the finding of the circuit court that MetLife's breach of the prepayment provision was material, noting that the provision was unique and had been heavily negotiated by the parties.

d. Turning to the issue of whether MetLife was entitled to a prepayment fee as a matter of equity, the appellate court (while noting that MetLife had not cited any authority in support of an "equitable prepayment penalty") ruled that MetLife had not suffered any harm because "[a]s the circuit court found, alternative security instruments yielding at the same or greater rate as the loan's note were available for purchase by MetLife at the time of prepayment." The court noted that at the trial the circuit court had determined that the testimony of Mart Owners' expert was more credible regarding the availability of specific commercial backed mortgage securities, and refused to "second guess" the trial court or hold that its finding in this regard constituted reversible error.

e. The appellate court next rejected MetLife's claim that it had been erroneously deprived of its right to a jury trial (finding that MetLife had never indicated that it wanted the issues tried by a jury). Finally, the court also rejected MetLife's claim that the circuit court erred in denying its post-trial motion seeking to reopen the proofs so that it could offer evidence (not submitted at the trial) that would support a "middle ground" of approximately $20 million. MetLife sought to introduce new evidence concerning the yields on corporate bonds rated below the A-rated bonds that MetLife had selected as comparable security instruments. MetLife argued that although the circuit court had held that MetLife did not select the comparable instrument in good faith it should be allowed to prove its "actual damages" and not forfeit all rights to a prepayment fee, which would result in the Mart Owners being unjustly enriched. However, the appellate court agreed with the reasoning of Judge Arnold (who succeeded Judge Reid as circuit court judge and heard MetLife's motion on this matter), who "concluded that MetLife's failure to offer evidence of a 'middle ground' prepayment penalty at trial was the result of MetLife's own deliberate 'all or nothing' trial strategy." The appellate court refused to rule that the circuit court abused its discretion in denying MetLife's motion on this issue, and stated that "there is no indication from the record that the proofs MetLife sought to introduce were not available at the time of trial." The court further found that even if MetLife had been able to introduce such evidence, it "would not have changed the court's judgment since the evidence would not have gone to the salient issues of MetLife's breach or MetLife's entitlement to equitable relief."

f. MetLife subsequently elected to appeal the appellate court's decision to the Illinois Supreme Court, but the case was settled in early 2003 for an undisclosed amount.

Reporter's Comment No. 4: The moral of the *Metropolitan Life* opinion: stick with objective criteria for determination of the comparable prepayment security instrument and rate and never, EVER, draft a prepayment clause that provides for a subjective "good faith" determination of a security instrument of "comparable investment quality" as of the original date of the note (at least in Cook County, Illinois). There is a great risk in being a "pioneer" and deviating from standard industry practice in favor of a subjective determination. For a lender to do so is to act at its peril. An institutional lender is just asking for a court – at least in Illinois – to rewrite its mortgage and second-guess its decisions in order to reach an "equitable" result. A prepayment provision should be carefully and comprehensively drafted so that its meaning is clear and there is no ambiguity that may open the door to a challenge by a clever borrower. *See, e.g., Littlejohn v. Parrish*, 163 Ohio App. 3d 456, 463-64 (2005) (holding that mortgage, which provided that there was no prepayment penalty but that any prepayment was subject to the mortgagee's approval, imposed duty of good faith and fair dealing "when one party has discretionary authority to determine certain terms of the contract"; court refused summary judgment for mortgagee and remanded case for further proceedings). *Cf. Preserve at the Fort, Ltd. v. Prudential Huntoon Paige Associates*, 129 P.3d 1015, 1017-18 (Colo. App. 2004) (agreeing with trial court ruling that "the rider [to the deed of trust note executed by the plaintiff borrower] controls, negates or supplants any language in the note that might permit prepayment, and bars prepayment except as provided in the rider).

Reporter's Comment No. 5: The Circuit Court of Cook County, Illinois recently entered an interesting ruling on the enforceability of a commercial-loan prepayment provision. *See Cornerstone Leased Drugstores LLC v. Wells Fargo Bank Northwest*, NA, Circuit Court of Cook County, Illinois, No. 07 CH 04352 (June 19, 2009). This case was decided solely on the basis of the meaning of the contractual language regarding prepayment contained in the (identical) mortgage notes executed by Cornerstone Leased Drug Stores LLC ("Cornerstone") in connection with forty-two 25-year mortgages on properties located in 16 states. The Court agreed with the defendant, Wells Fargo Bank Northwest ("Wells Fargo," which served as trustee for the five institutional lenders who actually loaned the money and were designated as trust-beneficiaries) with respect to its calculation, under each of the notes, of the Reinvestment Yield under the prepayment provision and the conversion to a monthly yield as provided by the provision. This case, as with the ones cited and discussed earlier, has direct relevance for commercial mortgage lenders.

The court summarized the issues as follows:

> "There are two portions of [the prepayment provision] that are critical to the resolution of the dispute between the parties. The first is part (i) of the definition of "Reinvestment Yield," and in particular the parenthetical statement: "(or such other display as may replace such displays on the Bloomberg service or any other generally available service)." The second is contained within the definition of "Prepayment Consideration" providing the method of calculating the total amount of the remaining payments due under the note: "such sum to be determined by discounting (monthly on the basis of a 360-day year composed of twelve 30-day months)."

The prepayment premium was to be calculated (pursuant to the applicable provision) by reference to the "Reinvestment Yield," which, as stated in the provision,

> "means the yield to maturity of either (i) the yield reported as of 11:00 A.M. (New York City time) on the date of calculation on the display designated USD on the Bloomberg Financial Markets Screen (or such other display as may replace such displays on the Bloomberg service or any other generally available service) for actively traded U.S. Treasury securities having a constant maturity equal to the remaining average life of the Note, or (ii) if such yields shall not be reported as of such time or the yields reported as of such time shall not be ascertainable (including by way of interpolation), the Treasury Constant Maturity Series yields reported for the latest day for which such yields shall have been so reported as of the Business Day next preceding the Determination Date in Federal Reserve Statistical Release H-15 (519) (or any comparable successor publication) for U.S. Treasury

> securities having a constant maturity equal to the remaining average life of the Note as of the Determination Date: provided however, if no maturity exactly corresponding to the remaining average life of the Note shall appear therein, yields for the two most closely corresponding reported maturities (with one being shorter and the other longer) shall be calculated pursuant to the foregoing sentence and the Reinvestment Yield shall be interpolated from such yields on a straight-line basis (rounding in each of such relevant periods, to the nearest month). All such prepayments must occur on a Business Day."

Cornerstone subsequently refinanced the loan and exercised its right to prepay in the summer of 2006. However, on the stipulated date for calculation of the prepayment premium (August 16, 2006), a "matched" Treasury security that would mature on the maturity date of the loan (March 3, 2019) did not appear on the Bloomberg USD screen. The parties then agreed, as per the language in the prepayment provision, to interpolate the prepayment consideration using the two most closely corresponding reported U.S. securities, one shorter than March 3, 2019 and one longer. But the parties disagreed on whether they could only look to the Bloomberg USD screen to ascertain such interpolation based on the U.S. Treasury securities most closely corresponding to March 2019 (as argued by Wells Fargo), or whether the parties could look to different screens for such purpose (as argued by Cornerstone). The court ruled in favor of Wells Fargo, noting that "Paragraph 6 [the prepayment provision] of the Notes, while admittedly complex, is not ambiguous." The court further noted that: "The plain language of the note anticipates the possibility that changes might occur over the course of those 25 years, but does not provide the parties with an alternate financial markets screen from which to obtain information on the interest rate borne by U.S. Treasury securities."

Cornerstone also argued that the Reinvestment Yield should have been calculated on a semi-annual, rather than a monthly basis. But after carefully reviewing the language in the prepayment provision, the court agreed with Wells Fargo that in order to be consistent with the terms of the Notes the Reinvestment Yield had to be calculated on a monthly basis. According to the court:

> "Since the discount factor is comprised of the "Reinvestment Yield plus 50 basis points," the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number. The word monthly in this section of the note provides the clear and unambiguous direction for that calculation. As such, there is no issue of material fact . . . and Wells Fargo's Motion for Summary Judgment is granted."

Reporter's Comment No. 6: The basic purpose of a yield-maintenance prepayment provision in a commercial real-estate loan document is to provide a fee to the lender that will compensate it for the difference between the original interest on the loan and the yield available from U. S. Treasury instruments at the time of prepayment. The prepayment clause in the Cornerstone case provided that "the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number." This adding of basis points, which is not all that common any more in connection with prepayment-premium provisions in commercial mortgage-loan documents, was probably done by the lender to blunt any argument that prepayment based on U.S. Treasury instruments without the addition of such basis points would constitute a "windfall" for the lender. But this specific language (certainly not a bad idea) had no bearing on the court's ruling, which was based strictly on contractual interpretation; this was not a true "yield maintenance" case where the validity or enforceability of such a clause in general was questioned. For years, institutional lenders such as insurance companies have used "yield maintenance" clauses to calculate prepayment premiums, and such clauses are considered the industry norm.

See, e.g., Richard F. Casher, *Prepayment Premiums: Hidden Lake is a Gem,* 19-9 ABI J. 1 (Nov. 1, 2000):

A yield-maintenance clause typically assumes that the prepayment premium and the prepaid principal will be invested in U.S. Treasury securities (Treasuries) that will mature at the same time as the prepaid loan and that the dollars so invested will return the same yield that the insurance company would have realized had its loan not been prepaid. Treasuries are used as the reinvestment norm because there exists no standard commercial mortgage loan rate, given the uniqueness of each commercial loan and the inherent difficulty (if not impossibility) of identifying an identical or similar loan; in contrast, the market for treasuries is deep and highly liquid.

See also Restatement (Third) of Property: Mortgages §6.2 comment a (1997):

> "The primary purpose of [prepayment] clauses is to protect the mortgagee against the loss of a favorable interest yield. . . . Prepayment may also result in further losses, such as the administrative and legal costs of making a new loan . . . and in some cases additional tax liability."

The *Cornerstone* case (at least at the trial level) once again, as with the other decisions cited above, clearly illustrates the importance of clarity in the drafting of a mortgage prepayment provision, and in the *Cornerstone* case it would appear the lenders (and their counsel) did it right. The borrower had contended that it was overcharged by $2,260,000 based on the defendant's calculation (the total prepayment amount paid to Cornerstone, pursuant to Wells Fargo's calculation, was $20,621,812). The court noted in its ruling that there was no ambiguity and therefore no need to examine parol evidence (although the court in the *BKCAP* case described above held otherwise based on the facts of the case). See also *Friedman v. LaSalle Nat. Bank*, 2004 WL 937304 (Ohio App. 11 Dist., April 26, 2004), at *3 ("[t]he prepayment provision is clear on its face and unambiguous. Therefore we will not consider the parol evidence [the borrower] advances")). It is almost impossible to overemphasize the fact that the mortgage prepayment provision should be carefully, clearly, and comprehensively drafted so that its meaning is clear and there is no ambiguity that may open the door to a challenge by a clever borrower. Most of the recent cases dealing with the enforceability of prepayment premiums in commercial loans deal with interpretation of the contractual language, not the validity of yield-maintenance provisions in general. The *BKCAP* case (*supra*) notwithstanding, the general rule is that any ambiguity will be construed by a court in the borrower's favor when the lender has drafted the loan documents. *See, e.g., Littlejohn v. Parrish*, supra Comment No. 4, 163 Ohio App. at 463-64.

Reporter's Comment No. 7: When it comes to the enforceability of prepayment premiums, language does matter!

The Reporter for this item was Jack Murray of the First American Title Insurance Chicago office.

MORTGAGES; SUBROGATION: Even if a refinancing lender's lack of knowledge of existing contractually subordinated encumbrances is due to its own neglect, when its borrower accepts a mortgage whose proceeds are used to pay the superior loan, the refinanced loan remains superior to the subordinate encumbrances. ***UPS Capital Business Credit v. Abbey, 2009 WL 2046157 (N.J. Super. Ch. Div. 2009); June 26, 2009.***

A homeowner borrowed $800,000 from a bank. The loan was secured by a mortgage. The borrower then took $187,450 from a second bank, and the first bank agreed to subordinate its mortgage to the later recorded mortgage. The borrower then borrowed $185,000 from a third bank, the successor-in-interest to the second bank. Those funds were used to pay the second loan. The title insurance commitment obtained at the time of the refinancing did not reference the $800,000 mortgage. Neither did the borrower's affidavit of title.

When the borrower defaulted, the third bank filed a foreclosure complaint but, through mistake and inadvertence, it did not list the first bank in the foreclosure complaint. The first bank then claimed that its lien had priority. The first bank argued that when it executed a subordination to the $187,450 loan, it only agreed to be subordinate to that mortgage and any renewals or extensions. It argued that the $185,000 mortgage loan from the third bank, as successor to the second bank, was neither a renewal nor an extension, but was a new loan. The first bank claimed that once the $187,450 mortgage had been satisfied, its $800,000 mortgage regained first lien priority.

The Court disagreed, finding that the $185,000 loan, which was from the holder of the superior loan, was in effect a modification and renewal of the $187,450 mortgage because it served to extend its term for a lower interest rate. Therefore, the Court found that first bank's subordination agreement applied to the $185,000 mortgage "modification" and its $800,000 mortgage was inferior.

It further found that, pursuant to the doctrine of equitable subrogation, the successor-in- interest bank had priority notwithstanding the fact that it was negligent in failing to discover the existence of the $800,000 mortgage. The Court pointed out that equitable subrogation is favored and is applicable as long as the third bank did not know of the first bank's mortgage even if it was the result of

negligence. Therefore, the Court found that the third bank's mortgage had priority over the $800,000 mortgage.

The Court looked for the appropriate remedy to mitigate the first bank's exclusion from the foreclosure proceedings. In actions for strict foreclosure, the senior lien holder can force the junior lien holder to either redeem the senior mortgage debt or forfeit the lien. Strict foreclosure cannot be used to extinguish a junior lien if the lienholder was intentionally excluded from the foreclosure action. However, in this case, the failure to list the first bank in the foreclosure action was by mistake. Nonetheless, the Court found that the application of strict foreclosure in this case to compel the first bank to either redeem the third bank's mortgage or lose its lien was inappropriate based on the fact that the first bank never had the opportunity to bid at the sale. Therefore, the Court vacated the sheriff's sale and required the third bank to refile its reforeclosure complaint to extinguish the first bank's lien.

Editor's Comment 1: Although essentially mooted by the court's ruling on equitable subrogation here, the question of whether a replacement loan from a new lender is an "extension or renewal" of the original loan is a nice one. The editor suspects that most in the industry believe an "extension or renewal" is an agreement between the mortgagor and the holder of the mortgage. But does it really make any difference? The subordinating lender typically would not have the power to prevent the senior lien from being sold to another lender, so why should it care if another lender comes in and pays of the old loan? The subordinating lender would argue "injury or no – that's not the deal." Would it be right?

Comment 2: As indicated above, the issue in comment 1 becomes moot when the court concludes that anyone who refinances a senior lien and takes and records a new loan is subrogated to it as against junior lienholders. The Restatement of Mortgages rule is that such a party is entitled to such benefit even if it has knowledge of the junior lien and, perforce, if it doesn't have knowledge, but this is due to culpable negligence.

Note that New Jersey rule doesn't move to the Restatement approach, at least not yet. Subrogation is available only where the refinancing lender is unaware of the "sandwiched" loan, albeit through negligence. Note that missing an $800,000 lien here when you are lending only $180,000 is a pretty big mistake. New lender got very lucky.

OPTIONS; RIGHT OF FIRST OFFER; NOTICE: Final Notice of 24 hours was a reasonable time to exercise right of first offer in connection with sale of real property when holders of right had been contacted months before to inquire whether they had any intention to exercise the right and they did not respond. ***Treinen v. Kollasch- Schlueter, 902 N.E.2d 998 (Ohio App. 1 Dist.).***

Plaintiffs Buyers sued Seller for specific performance of a right of first offer encumbering four adjoining lots. Buyers and Selleer ostensibly granted to each other a reciprocal right of first offer on the four adjacent lots and their accompanying housing units. The agreement's language extended the right to the parties in the contract, "their heirs, successors, and assigns," and also stated that the right of first offer constituted a covenant running with the land with the sale price to be determined by and Federal Housing Administration ("FHA") appraisal.

The Court stated that this granting language likely violated the Rule Against Perpetuities, but because the Rule was not pleaded as an affirmative defense, it was waived.

Over time, apparently, the Seller's property had been sold several times, but prior sellers had never notified the Buyers of the sales and they had never been afforded the right of first offer. The current successor Seller was several transfers removed from the original covenantors.

At the time Seller decided to sell her lots she notified the Buyers in writing that a sale was imminent, but Buyers did not express to Seller any interest in buying the lots. Rather than contacting Seller directly to inform her of their intent to exercise their first offer rights, they contacted an attorney. But the attorney did not contact the Buyers to express their interest in buying the lots.

On August 9, 2005 Seller sent a letter to the Buyers indicating the FHA appraised fair market value of the property (10 percent lower than the price Seller had agreed to sell to a third party) and that the Buyers had until August 15, 2005 to offer earnest money and to

obtain a prequalification letter from a lender. The Buyers did not respond to the letter, but instead sent the letter to their attorney. A second letter was sent to the Buyers on August 15, 2005 indicating their right of first offer would expire the next day. The Buyers again forwarded the letter to their attorney who then wrote a letter to the Seller questioning the accuracy of the FHA appraisal, but the letter did not indicate the Buyers interest in buying the lots or their intention to exercise their right. Buyers argued that Seller had a duty to rescind the contract for sale of the property, but they did not provide any law supporting their contention.

Buyers argued that the Seller had already repudiated the Buyers rights by contracting to sell to the third party. The court treated this as a "no brainer" – the deal with the third party could always be rescinded if Buyers exercised their rights. The Court also determined the appraisal satisfied the contract condition of offering the property at an FHA-appraised price.

The final argument by the Buyers is that the 24-hour window for them to provide an offer was unreasonable. The Court disagrees with this argument because the Buyers had multiple opportunities and months of time, to inform the Seller that they were interested in exercising their right of first refusal. The Court held under the facts that the Seller had complied with her obligations under the right of first offer.

OPTIONS; RIGHTS OF REFUSAL: Where a right of first refusal in a lease does not guarantee the landlord-seller a particular net recovery and does not require a tenant to pay the brokers' commission, a tenant is only required to match the gross sales price in the third-party offer and the landlord is obligated to pay whatever brokerage commissions are set out in the lease ***St. George's Dragons, L.P. v. Newport Real Estate Group, L.L.C., 407 N.J. Super. 464, 971 A.2d 1087 (App. Div. 2009); June 3, 2009***, discussed under the heading: "Landlord/Tenant; Purchase Options; Rights of Refusal."

RAILROADS; EASEMENTS; ABANDONMENT: Even where original deed to railroad purports to convey "a strip of land . . . forever," such deed is not a grant of fee simple to the railroad, but only an easement, when the deed is further qualified by expressions of purpose that the strip of land is to be used for a right of way for railroad purposes. ***Timberlake, Inc. v. O'Brien, 902 N.E.2d 843, (Ind.App. 2009)***, reported under the heading: "Easements; Abandonment; Railroads".

RECORDING ACTS; *LIS PENDENS*: In New York, a Notice of Pendency (*lis pendens)*does not create a property interest and a contract-buyer who files such a notice, but does not record its contract. The filer does not have a superior right under the recording statutes over a good faith purchaser for value that records its deed for the same property from the same seller as was named in the Notice of Pendency but who records his deed after the Notice. ***2386 Creston Avenue Realty, LLC v. M-P-M Management Corp., 867 N.Y.S.2d 416 (App. Div. 2008) (November 18, 2008).***

A closing pursuant to a real estate sales contract was scheduled to take place on November 1, 2004. By reason of outstanding building violations, it was postponed to give the seller time to clear those violations. For several months, letters flew back and forth between the parties' attorneys and on February 14, 2005 the seller cancelled the contract. Unbeknownst to the buyer, the seller had found another purchaser. Sale of the property to that other purchaser took place on February 14 as well. The purchaser was not aware of the prior unrecorded contract with the original contract-buyer. On February 22, the title company delivered a deed to the recording office and the deed was recorded on March 1.

On the same day that the deed was delivered to the recording office, the original contract-buyer filed a "notice of pendency" against the property and filed suit against the seller for specific performance and against the new owner under the theory that the new owner had intentionally interfered with the prior contract and was complicit in a conspiracy to defraud. There was no evidence that the new owner knew of the first contract. The suit against it was dismissed.

On appeal, the buyer argued that, as a contract-buyer seeking specific performance, "its filing of a notice of pendency was the proper vehicle to protect its rights pending the outcome of the litigation, even if the filing did not, in an[d] of itself, create an interest in the property." The Appellate Court rejected that argument.

New York law holds that a notice of pendency may be filed in connection with a lawsuit where the judgment "would affect the title to, or the possession, use or

enjoyment of, real property. . . .” It would be constructive notice, from the date of filing, for purchases or encumbrances. Where a “conveyance or encumbrance is recorded after the filing of a notice,” a purchaser or encumbrancer is bound by all of the proceedings to the same extent as the property owner itself. Also under New York law, unrecorded contracts are “void as against any person who subsequently purchases or . . . contracts to purchase . . . the same real property.” Therefore, “[a] good faith purchaser whose deed is recorded . . . thus takes precedence over a purchaser with an unrecorded contract of sale and no deed.” Under New York law, “[t]he filing of a notice of pendency does not substitute for the recording of the contract of sale or the conveyance.” Its purpose is “to afford constructive notice from the time of the filing so that any person who records a conveyance or encumbrance after that time becomes bound by all of the proceedings in the action.” It does not create rights that did not already exist.

According to the Court, “since a notice of pendency does not serve to create rights, [the original contract-buyer] could not obtain a superior right under the recording statutes over [the ultimate purchaser who was], a good faith purchaser for value from the same vendor [and] who recorded a conveyance.” If the contract-buyer had a superior enforceable interest in the property, then the ultimate purchaser would have been bound by the outcome of the litigation. Further, according to the Court, specific performance was not available since the seller “did not have title to the subject property at the time that the action was commenced.” The Court summed up the situation as follows: “New York’s ‘race-notice’ statute protects good faith purchasers who record first. [The ultimate purchaser] took advantage of the statute and recorded, but [the original contract-buyer] did not. While ‘the status of good faith purchaser for value cannot be maintained by a purchaser with either notice or knowledge of a prior interest or equity in the property, or one with knowledge of facts that would lead a reasonably prudent purchaser to make inquiries concerning such,’ . . . [the original contract-buyer had] failed to demonstrate that [the ultimate purchaser] had knowledge of [its] contract with [the same seller] and thus was not a good faith purchaser.”

Reporter’s Comment 1: The opinion did not state such, but one wonders if the original contract-buyer’s attorney was primarily a litigator and did what litigators do – file the Notice of Pendency. Query – how many attorneys would have recorded the contract or a memorandum of contract. In New Jersey (and this case was NOT in New Jersey), there is a procedure for filing a notice of settlement for contracts and for prospective mortgages. It “saves” a place in the recording line for 45 days after its filing and does not need to be signed by other than the attorney.

Reporter’s Comment 2: New York is a Race-Notice state, and it would seem that its recording scheme trumps its civil procedure scheme that would otherwise make persons whose conveyances or encumbrances recorded after the filing of the Notice of Pendency bound by the outcome of the related litigation.

Editor’s Comment: One assumes that a party filing a lawsuit alleging an equitable interest in the property or an adverse possession claim not based upon a written contract would provide notice successfully simply by filing the notice of pendency. An interest distinction, and one not anticipated by editor.

The Reporter (and author) of this item was Ira Meislik of the New Jersey Bar.

TITLE INSURANCE; EXCEPTION DOCUMENTS INCORPORATED BY REFERENCE: While it is not against public policy to except from title insurance coverage certain matters by reference to the provisions of a separate instrument, the matters excepted must be clearly, precisely, and unambiguously stated in such instrument. ***Crossman v. Yacubovich, et al., 290 S.W.3d 75 (Mo. App. Ct. 2009).***

In connection with the purchase of a home, the Crossmans obtained title insurance from Lawyers Title. Schedule B-II of the title commitment asserted an exception to coverage for “[b]uilding lines and easements according to the plat” (the “Exception”) of the Shadow Creek Plat Two subdivision. None of the survey, title commitment, or title policy mentioned a pipeline or pipeline easement. Shortly after the Crossmans completed the purchase, Explorer Pipeline representatives came through the neighborhood to clear its easement of trees and structures, removing nine trees from the Crossmans’ property and alerting the Crossmans that their work shed would be removed. In this process, the Crossmans first learned of an easement for a petroleum pipeline that crossed over half of their back_yard and effectively prevented them from improving the yard.

The Crossmans sought coverage under their title policy for loss arising from the restricted use and diminished value of their property. The title company denied coverage under the Exception. In response, the Crossmans filed a claim against the sellers, the title company, the surveyor, and the insurer, asserting a variety of claims. The trial court granted the title company's motion for summary judgment based on the Exception. The Crossmans appealed, arguing that the trial court erred because the insurer failed to establish that the policy exception expressly and specifically excluded coverage.

On appeal, the Missouri Court of Appeals discussed title insurance generally and described how title exceptions operate to eliminate from coverage certain items which are identified on Schedule B of the title policy. Quoting from a treatise, the court stated that "if a lien, encumbrance or other title defect is to be excepted from coverage, the title insurer must use clear, precise[,] and unambiguous language in the exception." The court also cited other Missouri cases which held that "provisions limiting or cutting down, or avoiding liability in the coverage made in the policy are construed most strongly against the insurer." Any "ambiguities in the terms of the insurance policy, including ambiguities in the exceptions, generally are strictly construed against the insurer."

The court noted that while title policies may except a matter from coverage by reference to the provisions of another instrument without setting forth in detail the content of those provisions, if the separate instrument "is determined to be ambiguous, then the provision incorporating it becomes ambiguous." Here, the court held that the plat "fail[ed] to clearly, precisely, and unambiguously identify the petroleum-pipeline easements crossing the homeowners' property" because (1) in places, the plat referenced an easement in the singular, (2) the plat made no reference to the nature of the pipeline easement that would alert a reasonable person to the existence of petroleum-pipeline easements or easements which existed for purposes other than ordinary utility purposes, and (3) testimony from the surveyor that the surveyor could "see how the easement would not be clear upon a cursory review of the plat" and that the plat shows the easement in a "substandard way." As a result, the Exception did not "clearly, precisely, and unambiguously except the petroleum-pipeline easements from coverage," and the court reversed the trial court's holding.

Comment: Of course, exceptions from coverage by reference to plats, Declarations, and various other documents, are the standard rule. It is a rare residential client sophisticated enough even to ask for the reference documents. In most cases, one assumes that the title insurers simply take the risk, or will after this case, that the reference documents clearly delineate any problems.

Note that the court draws a narrow line. If the plat indeed was so ambiguous that the easement couldn't be identified, the Crossmans would have prevailed against the easement and, presumably, the title company would have had to defend. So the reach of this case is not very long.

TITLE INSURANCE; MECHANICS' LIENS; PRIORITY: Absent clear and unambiguous language in a title insurance policy, a court will not interpret the provisions of the policy so as to limit coverage for loss or damage arising out of mechanic's liens on "removable improvements" and fixtures. ***GCI GP, LLC v. Stewart Title Guaranty Co., ___ S.W.3d ___, 2009 Westlaw 943777 (Tex. Ct. App. 2009).***

Paul Frame ("Frame") bought a residence in 1997 and hired Aspen Custom Builders ("Aspen") for certain renovations. On August 24, 2001, while the renovations were still being made, Frame executed a promissory note in the amount of $4,319,731.39 to Comerica Bank-Texas ("Comerica"), which was secured by a deed of trust. In September 2001, Comerica purchased a mortgagee title insurance policy from Stewart Title Guaranty Co. ("Stewart Title"). Aspen performed work on the house until 2003 when it stopped due to non-payment and filed a mechanic's lien against the property. Also in 2003, Frame defaulted on the promissory note, and on August 12, 2003, Comerica noticed the property for foreclosure sale. On August 29, 2003, Aspen filed suit against Frame and Comerica. On the same day, Comerica sold the note and deed of trust to GCI GP, LLC ("GCI") for $4,000,000. On September 2, 2003, GCI proceeded with the scheduled foreclosure sale and purchased the property for $2,000,000. Aspen then amended its suit naming GCI as a party.

In its suit, Aspen claimed it had a contract with Frame to make improvements to the house, and that the labor it performed commenced on June 18, 1997, and therefore the inception date of Aspen's mechanic's lien predated Comerica's note and the date of the title policy. Aspen

sought a declaratory judgment that its lien was superior to Comerica's note. Alternatively, Aspen sought foreclosure on the fixtures that could be removed without damage if the trial court found that Comerica's lien was superior to Aspen's. Here is the text of this alternative plea for relief:

> "foreclosure on the fixtures that could be removed without damage, including palm trees, pool equipment, air conditioning units, electrical control panels, appliances, wine cooler units, a fireplace mantel, decorative columns, mahogany columns and paneling, custom carved moldings, an elevator, light fixtures, bathtubs or whirlpools, stained glass domes and panels, window treatments, a steam unit, a dry sauna, water heaters, safes, cabinets, marble or granite or composite countertops, plumbing valves and fixtures, exterior stone (not installed), antique entry doors, wrought-iron fencing, landscape plants, carpet in the guest house, and windows and doors."

Concurrently, GCI demanded that Stewart Title provide indemnification against Aspen's claims and a defense to Comerica and GCI. Stewart Title provided counsel to defend GCI, but limited such counsel's representation to defending GCI, as it refused to prosecute a counterclaim filed by GCI in the lawsuit. After reviewing the facts of the case, a Stewart Title attorney informed GCI that the mechanics lien on the property had been extinguished by the foreclosure sale, but that Aspen may have a claim as to the "removables." Stewart Title also informed GCI that "removables" may not be covered under GCI's policy. According to GCI, Stewart Title informed GCI that it would contribute "zero" to any settlement reached between GCI and Aspen. Nonetheless, GCI entered into a settlement agreement with Aspen regarding Aspen's liens wherein GCI agreed to pay $300,000 in exchange for Aspen's dismissal of all claims against GCI with prejudice and a release of liens.

On December 30, 2003, Stewart Title sent a letter to GCI denying coverage related to the settlement payment, prompting GCI to sue Stewart Title for breach of the insurance contract and its duty of good faith and fair dealing. Stewart Title filed a motion for summary judgment, asserting that the title policy did not cover suits filed by contractors who were not paid for "removable" improvements that could be removed without causing material damage to the property and contending that the items subject to Aspen's claims were personal property and therefore not covered by the policy. Stewart Title's arguments were premised on the contention that the title policy only covers "risks and claims 'against the land that is insured.'" The policy also defined land as "the land described [in the policy], and improvements affixed thereto that by law constitute real property." GCI filed its own motion for summary judgment, asserting that the policy insured it against "loss or damage sustained by the lack of priority of [its] lien," and, alternatively, that coverage still existed for "removables" because they are no longer personal property once affixed to the land. The trial court granted Stewart Title's motion for summary judgment, and GCI appealed.

On appeal, the court looked closely at the construction of the title insurance policy, focusing on two of the eight specifically-provided circumstances which would result in Stewart Title indemnifying GCI for loss or damages. One provision of the policy stated that Stewart Title would indemnify GCI for losses incurred by reason of A[t]he priority of any lien or encumbrance over the lien of the insured mortgage." A second provision stated that Stewart Title would indemnify GCI for losses incurred due to the "[l]ack of priority of the lien of the insured mortgage over any statutory or constitutional mechanic's, contractor's, or materialman's lien for labor or material having its inception on or before Date of Policy."

In analyzing these provisions, the court first noted the general rule of construction in interpreting Texas insurance contracts: courts must "consider the entire contract 'in an effort to harmonize and give effect to *all the provisions* of the contract so that none will be rendered meaningless.'" With respect to insurance contracts, courts generally "adopt the interpretation that most favors coverage." The court noted that an "intent to exclude coverage must be expressed in 'clear and unambiguous language.'" Applying these general principles, the court concluded that interpreting the entire title policy as limiting coverage of loss or damage to only "risks and claims 'against the land that is insured'" would be too narrow an interpretation and would be unsupported by the plain language of the policy, and to do so would have nullified the specific coverage of the policy and rendered it meaningless.

Accordingly, the court looked to Texas statutory and case law to determine the priority of the liens in question, and what effect "removables" have on such priority. After

reviewing Texas case law, the court held that mechanics liens have priority "over a prior lien, encumbrance, or mortgage on the land when improvements made could be removed without material injury to the land . . .," and concluded that the subject policy, which specifically covered mechanic's liens, was intended to indemnify for loss or damage arising out of mechanic's liens on "removable improvements" (including fixtures).

Comment: Reading between the lines, it appears that Texas law permitted GCI's mortgage to prime the mechanic's lien on the land itself, but not on the "removables." Missouri has a somewhat similar "bifurcated" lien concept.

One of the problems in the case, which the editor could not resolve by studying the opinion, is the distinction in Texas between "removables" and "fixtures." First, it seems clear that GCI's lien covered land, including items that, outside of Texas at least, would be fixtures, and that typically some things that are fixtures can be removed without damage to the land, and could be termed "removables."

It also seems clear that Aspen's lawsuit involved lots of things that in fact constituted fixtures, at least at common law. Look at the list in Aspen's complaint, quoted above. It may be, though, that Texas mechanic's lien law has a definition of "removables" that excludes all fixtures. This doesn't appear so from the language or outcome of the case, but it may have been uncertainty about this issue that led Stewart Title to deny coverage.

VENDOR/PURCHASER; MERGER BY DEED: Although deed purports to transfer property subject to a stated easement, court will look both to the sales agreement and the deed to determine whether an easement was intended. ***Shah v. Smith, 908 N.E. 2d 983 (Ohio App. 2009).***

Shah owned two adjacent parcels served by a joint driveway on the border between them. The joint driveway was identified by a recorded easement that apparently predated Shah's ownership of the two parcels.

Shah sold one of the parcels to Smith. The agreement (poorly written is an understatement) provided at one point that "Buyer will accept the Property subject to restrictions of record." It also stated that seller would transfer marketable title "free of . . . easements." Another part of the agreement said that the deed was to be delivered "free and clear of all liens and encumbrances except as otherwise provided herein."

The deed that was delivered specifically stated that title was subject to the recorded easement.

For years, the neighbors quarreled about the use of the shared driveway, culminating with the Smiths erecting a fence on the property line in the middle of the driveway.

A magistrate found for Shah, holding that the easement existed, but the trial court reveresed.

The appeals court reversed the trial court and reinstatement the easement.

The case involves two separate merger doctrines, argued by the parties.

The first doctrine is "merger by deed." Shah argued that since the deed referenced the easement, that was the final statement of the agreement of the parties, and thus the easement was valid. Certainly an easement of access is not a "collateral agreement" and, so far as the editor knows, does not fit within any other exception to the merger by deed doctrine. But the appeals court refused to apply it. The court properly referred to it as a canon of construction that is useful in resolving the intentions of the parties. But then it refused to apply the doctrine here.

It is virtually impossible to make out the court's reasoning based on the opinion alone. Inferentially, it would appear that the court will "look behind" the merger doctrine to see if the sales agreements provide clues as to the parties'' intentions, and then, if it finds something, will use both the deed and the agreement in interpreting that intent. Here, the court concluded that the sum of all the language in the deed was that title was to be transferred subject to recorded encumbrances, including the easement in question. It chose to ignore, or view as qualified, the language stating that title would be free of easements. The fact that the parties in fact referred to the recorded easement in the deed sealed the deal for the court.

The second merger doctrine is "merger by ownership." The court acknowledged that when Shah acquired the servient and dominant properties together, the easement between them disappeared. But the court held,

essentially, that Shah had the power to revive the easement by referring to it in the deed, which Shah did.

Comment 1: The editor has little quarrel with what the court did, since the editor believes that the contractual intent of the parties ought to be the court's "polestar" and when the contract conflicts with the deed, both documents ought to be evaluated. Obviously, BFP's will cut off the argument and will be able to rely on the deed, but that was not the case here.

Having said the above, the editor believes that the court's opinion denying application of the merger doctrine to credit the deed is not supported by the holdings to which it cites. Those cases involved collateral duties and did not relate to the central issue of title contained in the conveyance documents. There is plenty of loose language in those cases, however, to support through *dicta* what the court did here.

Comment 2: The notion that a seller can revive a recorded easement upon retransfer strikes the editor as perfectly acceptable. Why not?

VENDOR/PURCHASER; RECORDING; *LIS PENDENS:* In New York, a Notice of Pendency (*lis pendens)*does not create a property interest and a contract-buyer who files such a notice, but does not record its contract. Consequently the filer does not have a superior right under the recording statutes over a good faith purchaser for value that records its deed for the same property from the same seller as was named in the Notice of Pendency but who records his deed after the Notice. ***2386 Creston Avenue Realty, LLC v. M-P-M Management Corp., 867 N.Y.S.2d 416 (App. Div. 2008) (November 18, 2008),*** discussed under the heading: "Recording Acts; *Lis Pendens*."

WORDS AND PHRASES; "EXTENSIONS AND RENEWALS" OF MORTGAGES: A refinancing loan in the same amount of the original loan, but from a third party, is not an "extension or renewal" for purposes of a subordination agreement affecting the original loan, but the refinancing lender may qualify for equitable subrogation. . ***UPS Capital Business Credit v. Abbey, 2009 WL 2046157 (N.J. Super. Ch. Div. 2009); June 26, 2009.*** Discussed under the heading: "Mortgages; Subrogation."

ZONING AND LAND USE; CONSTITUTIONAL LAW; VAGUENESS: Zoning ordinance that prohibited certain uses of property in heavy industrial district was not unconstitutionally vague. ***Engel v. Crosby Twp. Bd. Of Zoning Appeals, 907 N.E.2d 344, (Ohio App. 1 Dist. 2009).***

Tonya Engel owned 162 acres of land in an area zoned "G-Heavy Industrial District." In April 2007, Steve Engel, Tonya's husband, applied to Espel, Crosby Township Zoning Inspector, for a zoning certificate. According to the application, Engel sought to develop a motorsports park on the land.

After Engel responded to Espel's requests for more detailed plans, Espel refused to issue the zoning certificate. Instead, he informed Engel that Engel would need to seek authorization for a motorsports park in the G-Heavy Industrial District from the Board of Zoning Appeals (BZA). A hearing was held before the BZA, at which Espel stated that, under Section 35.3.7 of the Crosby Township Zoning Resolution, the BZA had to decide whether the use was appropriate because it might emit smoke and noise.

The BZA denied the zoning certificate, finding that the use of the land as a motorsports park "may be obnoxious or offensive by reason of emission of odor, dust, smoke, gas, or noise and therefore may constitute a nuisance."

The Engels appealed the board's decision to the trial court. The trial court held that the board's denial of the zoning certificate was supported by a preponderance of probative, reliable, and substantial evidence; it therefore affirmed the denial of the certificate.

Engel appealed, asserting that the section of the resolution upon which the BZA based its decision was unconstitutionally vague. The appeals court noted that such an argument is "usually applicable only to criminal ordinances which fail to put persons on notice as to what conduct is prohibited." *Franchise Developers, Inc. v. Cincinnati*. 30 Ohio St.3d 28, 505 N.E.2d 966 (1987). Therefore, Engel's argument struck the court as inherently deficient in a zoning case where the zoning resolution, by its very nature, puts a property owner on notice that use of the property is subject to regulation. "Additionally, the appeals court pointed out that the Crosby Township Zoning Resolution contains a list of 70 specific prohibited uses and a catchall provision that

makes impermissible in general those uses which may be obnoxious or offensive by reason of emission of odor, dust, smoke, gas or noise. Noting that zoning resolutions necessarily require some generality to allow flexibility to deal with unforeseen potential uses of the land, the appeals court found that the words used in the section, when given their ordinary meanings, make clear what kinds of uses are prohibited. The appeals court thus concluded that the resolution is not unconstitutionally vague, and that the trial court did not err as a matter of law when it affirmed the BZA's decision.

Comment: The editor sees quite a lot of logic in the appellant's argument. A fair ordinance must give applicants some notion of what standards bind the decision makers. In a Heavy Industrial District – "offensive odor, dust, smoke, gas or noise" would seem to be the very reason that the District was created – so that such things wouldn't bother anyone but others emitting the same noxious impacts.

The appellant likely will have a better case based upon equal protection, comparing the impact of his activities to those already permitted in the district (assuming that there are some.)

ZONING AND LAND USE; CONSTITUTIONAL LAW; VAGUENESS; USE RESTRICTIONS: Ordinance prohibiting conditions that are "blighting factors" on a specific neighborhood was not void for vagueness. ***Willoughby v. Taylor, 906 N.E.2d 511, (Ohio App. 11 Dist. 2009).***

Taylor was charged with violating Willoughby City Ordinance 1309.08, for failing to maintain his residential property; Willoughby City Ordinance 1131.11(f), for failing to remove a utility trailer from his front setback; and Willoughby City Ordinance 1131.03, for using residential property for salvaging or recycling.

Taylor pleaded not guilty to the charges and filed a motion to dismiss. The trial court overruled appellant's motion and the matter proceeded to jury trial. The issue appeared primarily to be back yard junk. Taylor had had numerous discussions with the enforcement officer, and seemed unwilling or unable to clean the junk from his back yard.

At the trial, a next door neighbor testified in Taylor's behalf, noting that she had never observed his back yard because he maintained a privacy fence, and that the front of the house had been kept neat. A cross-the-street neighbor testified to the same effect. Apparently only one neighbor had any ability to see into Taylor's messy back yard at all. Evidence for the City consisted of pictures taken of the back yard junk from inside the yard. At the close of trial, the jury found appellant guilty of failing to maintain his residence and failing to remove a utility trailer from his front setback. The jury acquitted appellant of using his property for salvaging or recycling.

On appeal, appellant specifically challenged his conviction of violating Willoughby City Ordinance 1309.08. The ordinance requires residential property to retain a "level of maintenance in keeping with the neighborhood standards of the immediate neighborhood" and prohibits conditions which constitute "blighting factors" in relation to such standards.

Appellant contended these standards are not based upon an objective or established metric and, thus, their enforcement necessarily hinged upon the subjective. Accordingly, appellant argued the ordinance failed to provide clear notice regarding the conduct which prohibited, thereby empowering the city to arbitrarily and discriminatorily cite a resident without restraint.

The appeals court affirmed the conviction. Generally, it stated that an ordinance will not be considered overly vague where it provides "fair notice" to those who must obey the standards of conduct specified therein. *Baughman v. Ohio Dept. of Public Safety Motor Vehicle Salvage*. 118 Ohio App.3d 564, 574 (1997). Likewise, a statute will not be declared void simply because it could have been worded more precisely. See *Roth v. United States*, 354 U.S. 476, 491 (1957).

Here, the appeals court interpreted the language of the ordinance, with its assistive examples of prohibited conduct, as placing a person of ordinary intelligence on fair notice of the conduct prohibited. While acknowledging that the ordinance requires contextual analysis, the appeals court did not believe this implies the ordinance is unconstitutionally vague. To the contrary, the appeals court viewed such a requirement as a restraint on an investigator's discretion which would help prevent arbitrary or discriminatory enforcement. By requiring an inspector to compare a property with its surrounding neighbors and neighborhood, the ordinance compels the inspector to place his or her decision to cite

a property owner in a specific, verifiable context. The context of the neighborhood consequently controls the discretion of an inspector, thereby limiting, if not preventing, the possibility of discriminatory enforcement. The appeals court therefore held that the ordinance passes constitutional muster and is not void-for- vagueness.

Comment 1: If the ordinance is not too vague, does it unconstitutionally delegate the function of standard setting to non-governmental parties – i.e. the neighbors? Has this ordinance, as interpreted by the court, made failure to "keep up with the Joneses" a crime?

Comment 2: The editor is concerned that the focus of city enforcement is on maintaining the value of the individual's property, rather than maintaining the value of the neighborhood. The editor is concerned that this interferes with privacy, and agrees with Taylor that the standards established were overbroad and vague. In fact, the city's own explanation of the provisions indicated that the standards were not uniformly applied.

If the only thing wrong with Taylor's back yard was that it was weedy and brown, while the neighbors kept their backyards green and verdant, would Taylor still be in violation? Is that proper regulation?

Comment 3: The following comes from our Land Use professor here at UMKC, and the general editor of the Urban Lawyer – Julie Cheslik:

No sympathy for the homeowner from this quarter, Pat. I'd say the local government is well within its authority to act. This ordinance and its application to the property owner falls within the ambit of "providing for the general welfare" of the community whether its purpose is safety, maintaining property values or aesthetics.

The fact that a municipal ordinance requires an official to exercise a subjective judgment (What is blighted? When does the level of maintenance fall below the standards of the neighborhood?)does not render the ordinance unconstitutionally vague. Courts generally defer to the non-arbitrary exercise of judgment by municipal officers, perhaps guided by the notion that most municipal officers are not that quick to act against a non-compliant property owner. Most of these cases are only brought by the city after many attempts to work with and secure compliance from the property owner.

ZONING AND LAND USE; SPOT ZONING: Amendment that singled out cell towers and antennae for exceptions from building height requirements was not spot zoning. ***Scalambrino v. Town of Michiana Shores, 904 N.E.2d 673 (Ind.App. 2009).***

In 2006, T-Mobile and the Town of Michiana Shores began discussions regarding leasing land to T-Mobile for installing a cell tower. The Town Council passed a resolution authorizing the Town to proceed with the lease, the building commission issued an opinion letter stating that the cell tower would not violate the existing zoning ordinance, and the Town published notice of a public hearing regarding the issue of leasing property for the construction of a cell tower. At the Town Council meeting, the Town accepted T-Mobile's proposed site lease agreement. The Town subsequently signed the site lease, and the building commission issued a building permit for the construction of the cell tower.

Plaintiff then filed a complaint, requesting a permanent injunction on the grounds that the construction of the cell tower violated the Town's municipal code. In response, the Town sent notice of a Plan Commission meeting, at which an ordinance was passed to create a governmental zone, and the zoning map was amended to add the governmental zone.

Plaintiff then amended his complaint, requesting a declaratory judgment that the zoning ordinance was illegal and void on the grounds that it constituted spot zoning. The trial court granted summary judgment for the Town, and Plaintiff appealed.

The Appeals Court rejected Plaintiff's claim of spot zoning. Spot zoning is "the singling out of one piece of property for a different treatment from that accorded to similar surrounding land which is indistinguishable from it in character, all for the economic benefit of the owner of the lot or area so singled out." Spot zoning is not illegal *per se* in Indiana, but may be allowed if the zoning action bears a rational relation to the public health, safety, morals, convenience or general welfare. Here, the ordinance does not constitute spot zoning because it does not single out a particular parcel of property for special treatment. Rather, it specifically exempts cell towers and antennae from the height restrictions in the business districts. In total, the ordinance applies to ten parcels of property. Moreover, even if the ordinance does constitute spot zoning, it bears a rational relation to the public

health, safety, morals, convenience, and general welfare. The zoning ordinance discusses the public policy of developing cellular communication cells by erecting cell towers in such a manner as to limit the number and placement of towers in the Town. Improved cellular communications has a direct, positive effect on the safety and convenience of the town, and the Town's decision to supplement its revenues by leasing municipal property is rationally related to improving the Town's general welfare. Therefore, the trial court did not err in granting summary judgment for the Town.

ZONING LAND USE; VARIANCES; AREA VARIANCES: Where there is no evidence that strict application of zoning ordinances would result in an economic injury to builder, variance will be denied. ***Town of Munster Bd. Of Zoning Appeals v. Abrinko, 905 N.E.2d 488 (Ind. App.).***

Appellants appealed the decision to grant a developmental standards variance to construct a single-family residence. Appellants raised three issues on appeal, which the court of appeals consolidated and restated as the following single issue: Whether the trial court erred in reversing the BZA's grant of a developmental standards variance when the BZA found a practical difficulty pursuant to Indiana Code section 36-7-4- 918.5.

Precision applied for a developmental standards variance to construct a 4,200 square foot house on its property. The Munster Town Code section 26-512(3) requires an R1 zoned residence to have side yards totaling 25 percent of the entire lot width at the building line with a minimum of 10 percent on either side. Compared to other lots in subdivision, the Property is unique because it has an acute reverse pie shape, with the street frontage totaling 121.42 feet wide and the rear property line totaling 55.81 feet.

Precision sought a zoning variance to reduce the rear side yard zoning requirement from 25 percent to 20 percent due to the unique pie shape, while still maintaining the 10 percent on either side as required by the Munster ordinance. Precision's application explained that the variance would allow it to construct a single family home similar in size and style to the other residences in White Oak Estates.

The [BZA] voted 4-1 to grant the proposed variance. The trial court conducted a hearing on a neighbor's appeal petition and thereafter issued an Order, reversing the BZA's decision. The trial court concluded, in pertinent part: that given the record that a single- family home was being built amidst other similar single-family homes in that subdivision and that its size was similar to adjacent properties, the [BZA's] record was sufficient to support the first and second elements of I.C. [§] 36-7-4-918.5(a). But that it was insufficient to support the [BZA's] finding under subsection (3), that there is a practical hardship to the application of the zoning ordinance due to the configuration of the lot.

The court of appeals found that the evidence that indicates it is the lot shape, as opposed to the size of the house, which causes the practical hardship as lacking. The court further found that the BZA's finding of a practical hardship does not rest upon a rational basis because the supporting evidence is so meager. The court acknowledged that an area variance does not affect the use of the land, is less drastic in effect and does not pose the threat of an incompatible use in the neighborhood. The documentary evidence submitted by Precision to the BZA visualizes that the proposed home had difficulties complying with the zoning requirements because of the reverse pie shape of the lot. In further support of its claim of economic injury, Precision focuses on testimony before the BZA stating that the proposed house would have to be reduced by 300 to 400 feet if the zoning requirements had to be followed. Precision relied on the inference that a smaller house means less profit and therefore the BZA evidently determined that the smaller house would cause a significant economic injury. However, the appeals court's review revealed a record "completely devoid of any evidence establishing an economic impact by following the zoning requirement."

There was no evidence indicating the footage of other homes in the subdivision; no evidence leading to the conclusion that a smaller house is not similar in aesthetics to the adjacent homes; no evidence of Precision's financial hardship if it were to build a smaller home. The evidence submitted merely established that the proposed home had difficulties complying with the zoning requirements because of the shape of the lot. The appellate court found that none of the evidence supports the BZA's general finding that building the home would amount to practical difficulties if the builder had to comply with the ordinance because of the lot's reverse pie shape and that the basic findings "come very close to being merely a general replication of the requirements of

the ordinance at issue." *See Network Towers*, 770 N.E.2d at 845. Thus, the appellate court agreed with the trial court in that the quantum of legitimate evidence before the BZA was so "proportionately meager" that they could not but conclude that the BZA's finding did not rest on a rational basis. Therefore holding that trial court properly reversed the BZA's grant of a developmental standards variance because there was no rational basis for the BZA's finding of practical difficulties.

Comment 1: This was a slickly argued appeal, and the editor believes a properly reversed variance. The builder was not restricted from building a house on the lot, and in fact didn't demonstrate that the house it could build was any smaller or less valuable than other lots in the neighborhood. It argued simply that the lot shape prohibited it from building a "mini-manse" from which it could derive maximum profit. Surely this is not economic hardship, but the argument is a difficult one to make when the BZA has already decided that it is.

Comment 2: The inference (set forth in the caption) that the court will look to the profitability of this lot versus similarly situated lots in the same neighborhood is one drawn by the editor based on the language of the court, but he welcomes disagreement (although that is not always apparent.)