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RESPA Simplification: An Oxymoron?

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On November 17, 2008, the Department of Housing and Urban Development (HUD) published a final rule under the Real Estate Settlement Procedures Act (RESPA) that is curiously entitled "Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs." The new rule makes significant changes to the disclosures required to be provided to consumers in residential mortgage loans. According to HUD, the new rule will help consumers to shop for the lowest cost mortgage and to avoid the kinds of costly and harmful loans that have contributed to the current economic crisis. HUD estimates that its new rule will save consumers "nearly $700 at the closing table." Although only time will tell whether the revised disclosures provide the expected benefits, it is clear that these changes will impose significant burdens on the lenders and mortgage brokers who make residential mortgage loans covered by RESPA.

Revised GFE and HUD-1 Forms – Required January 1, 2010

For over 30 years, borrowers have been provided two disclosures about the closing costs of their residential mortgage loans – the Good Faith Estimate (GFE), which is given within 3 business days of application, and the HUD-1/HUD-1A Settlement Statements (HUD-1), which is given at closing. HUD's new rule is intended to help borrowers better understand the costs of residential mortgage loans by requiring more information to be included on both the GFE and the HUD-1. The new rule also is intended to further HUD's stated goal to promote consumer shopping among mortgage originators by allowing consumers to obtain meaningful GFEs without having to pay significant upfront fees. The following outlines certain key points about the revisions to these disclosures and new restrictions imposed on residential mortgage loan originators:

- Both the current rule and the new rule require a lender or mortgage broker to provide the GFE within 3 business days of receiving an "application", which is defined as the submission of a borrower's financial information in anticipation of a credit decision. Under the current rule, such a submission is not considered an application until it identifies the specific property to be financed. Under the revised rule, the term "application" is defined to include not only the property address and an estimate of the value of the property, but also "any other information deemed necessary by the loan originator." This revision allows the loan originator to determine the information it needs in order to issue a meaningful GFE.

- Under the new rule, once an applicant submits all the mortgage application information deemed necessary by the loan originator to process the GFE, the originator must deliver a GFE to the applicant within 3 business days. The new rule specifically prohibits a loan originator from requiring an applicant to submit supplemental documentation to verify the information provided on the application as a condition for providing a GFE. A loan originator may require an applicant to provide such verification information after the GFE

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has been provided, or may use its own sources before issuing a GFE to independently verify the information provided by an applicant.

- The new rule provides that, prior to giving the GFE, the only fee that a loan originator may require an applicant to pay is the cost of a credit report. This rule expressly prohibits a loan originator from charging any fee for an appraisal, inspection, or other similar settlement service until after the applicant has received the GFE. If the GFE is mailed to the applicant, the applicant is considered to have received the GFE 3 calendar calendar days after it is mailed, not including Sundays and legal public holidays. In the supplemental material accompanying the new rule, HUD justifies this limitation on fees as being consistent with the revised regulations recently issued by the Federal Reserve Board under the Truth in Lending Act.

- Unlike the GFE form currently is use, the revised GFE form included in new rule requires each loan originator to provide a summary of key terms of the loan for which the borrower applied, including the interest rate, the term of the loan, and information about any prepayment penalty, balloon payment, possible changes to a variable rate or to payment amounts, and possible increases to the loan balance. HUD included these loan terms over strong industry comments that recognize the confusing effect of including such terms, in slightly different form, on disclosures under both RESPA and the Truth in Lending Act.

- To facilitate a borrower's ability to obtain and compare various loan offers, the new rule requires that the closing costs and loan terms included in a GFE must remain available to the applicant for at least 10 business days from when the GFE is provided. However, the rule provides an exception to this general requirement for the interest rate and any charges and terms dependent upon the interest rate, including any points or credit for the interest rate chosen, the adjusted origination charges, and per diem interest. For the interest rate and related charges, the loan originator must indicate on the GFE the period during which the stated interest rate will be available, which may be shorter than the 10-day period required for other fees. After that time period, the interest rate and related fees could change until the interest rate is locked.

- Under the current rule and judicial decisions, the GFE is only an estimate of closing costs – a lender has no liability if the actual closing costs are higher than those disclosed on the GFE. Under the new rule, the GFE must specify not only the amount of the closing costs, but also the loan terms, and the loan originator generally is bound to both the closing costs and the loan terms listed on the GFE. If the actual closing costs exceed the amounts included on the GFE, the excess must be within the following tolerances:

    - For the origination charge, any transfer taxes and, once the interest rate is locked, any points or credit for the interest rate and the adjusted origination charge – the actual charges at settlement for the following may not exceed the amounts included on the GFE.

    - For charges for lender-required settlement services where the lender selects the third-party settlement service provider, charges for lender-required services, title services and required title insurance, and owner's title insurance when the borrower uses a settlement service provider identified by the loan originator, and for government

- o For all other settlement services included on the GFE – the amounts charged may change at settlement.

- The new rule specifies the following situations in which a loan originator will not be bound by the closing costs and loan terms provided in the GFE:

  - o Where "changed circumstances" result in either increased closing costs that would exceed the applicable tolerances or a change in the borrower's eligibility for the specific loan terms identified in the GFE. The new rule introduces the term "changed circumstances" to describe the narrow range of circumstances that may be the basis for providing a revised GFE or releasing the loan originator from the closing costs and loan terms provided in the original GFE. Changed circumstances include:

    - * Acts of God, war, disaster, or other emergency.

    - * Information particular to the borrower or transaction that was relied on in providing the GFE and that changes or is found to be inaccurate after the GFE has been provided.

      In order to discourage loan originators from providing generic GFEs that are not based on a preliminary evaluation of a particular borrower, the new rule presumes that every loan originator will rely on the borrower's name and income, the property address, an estimate of the property value, the requested loan amount, and any information contained in any credit report on the borrower in order to provide the GFE. Under the new rule, this information may later become the basis for a ''changed circumstance'' only if the loan originator can demonstrate that there was a change in the particular information or that it was inaccurate – a loan originator cannot claim a changed circumstance based on the fact that it did not rely on this information in providing the GFE.

      If, however, a loan originator documents that it relies on a limited range of information in providing GFEs to borrowers (presumably the borrower's name and income, the property address, an estimate of the property value, the requested loan amount, and any information contained in any credit report), the loan originator may provide a revised GFE based on any other information that results in increased closing costs or a change in the borrower's eligibility, even if the information was received by the loan originator prior to providing the GFE. A loan originator has the burden of demonstrating nonreliance on the collected information, but may do so by various means, including for example, through a documented record in the underwriting file or an established policy of relying on a more limited set of information in providing GFEs.

Examples:

- ➢ If the actual loan amount turns out to be higher than the loan amount indicated by the borrower at the time the GFE was provided, and certain closing charges that are based on the loan amount increase as a result, the loan originator may provide a revised GFE reflecting those higher amounts.

- ➢ If underwriting and verification show that a borrower's monthly income is substantially less than the income relied on in providing the original GFE, and the difference results in a change in the borrower's eligibility for that loan with those particular terms, the loan originator would no longer be bound by the original GFE. If a loan with different terms is available for that borrower, then the loan originator would have the option of providing a modified GFE. Alternatively, the loan originator could deny the loan altogether.

- ➢ On the other hand, if the loan originator relies on the information from the application about borrower's total assets in providing the original GFE, and those assets are not materially different from what was stated in the application, then the loan originator may not use the borrower's total assets as a basis for providing a revised or modified GFE.

* New information particular to the borrower or transaction that was not relied on in providing the GFE.

* Other circumstances that are particular to the borrower or transaction, including boundary disputes, the need for flood insurance, or environmental problems.

The new rule expressly provides that market price fluctuations by themselves are not "changed circumstances". For example, if the appraiser that a loan originator intends to use for a particular transaction raises its prices by $50 after the loan originator has provided a GFE, the appraiser's price increase would not be a ''changed circumstance'' allowing the issuance of a revised GFE. In the supplemental materials included with the new rule, HUD has committed to providing additional guidance on what constitutes ''changed circumstances'' during the implementation period.

- o Where a borrower requests changes to the mortgage loan – if the loan originator accepts the borrower's application on the requested terms, the loan originator must send a revised GFE within 3 business days of receiving the borrower's request.

- o Where the original GFE has expired – the loan originator has no obligation to send a revised GFE

- o Where the interest rate was not locked or any lock has expired – the interest rate and related fees may change. If the borrower later locks the interest rate, the loan originator must provide a revised GFE showing the locked interest rate and any revised interest rate-dependent charges and terms. All other charges and terms must remain the same as on the original GFE.

- In transactions involving new home purchases – if settlement is anticipated to occur more than 60 calendar days from the time a GFE is provided, the loan originator may provide with the GFE a clear and conspicuous disclosure stating that a revised GFE may be issued at any time up until 60 calendar days prior to closing. Unless this separate disclosure is provided with the original GFE, the loan originator may not issue a revised GFE, except as otherwise permitted in other situations.

If a loan originator provides a revised GFE in one of these permitted situations, the loan originator must document the reason that a new GFE was provided and retain this documentation for no less than 3 years after settlement.

- The revised GFE form prescribed in new rule significantly changes the way payments to loan originators, including yield spread premiums (YSPs) paid to mortgage brokers, are disclosed. In the block entitled ‘‘Our origination charge’’, the loan originator must include all charges (including any YSPs) that all loan originators involved in this transaction will receive, except for any points to be paid to receive a specific interest rate. The new rule also provides that a loan originator may not separately charge any additional fees for getting this loan, including fees for application, processing or underwriting services. The revised HUD-1 includes conforming changes.

- As initially proposed, the revised GFE would have required the loan originator to complete a table that demonstrated the trade off between interest rates and closing costs by comparing the terms of: (i) the loan presented in the GFE; (ii) an otherwise identical loan with a lower interest rate and monthly payments that will raise closing costs by a specific amount; and (iii) an otherwise identical loan with a higher interest rate and monthly payments that will lower closing costs by a specific amount. Although this "tradeoff table" remains in the final version of the revised GFE, a loan originator has the option to complete only the column for the loan for which the borrower applied.

- The revised HUD-1 has a new third page that compares the closing costs previously provided on the GFE to the actual costs included on the HUD-1, and discloses the permitted tolerances for these costs. Each designated line on the revised HUD-1 also now includes a reference to the relevant line from the GFE.

- The new rule provides that, if a loan originator violates any requirements regarding the GFE, the violation will be deemed to be a violation of section 5 of RESPA. If any charges at settlement exceed the charges listed on the GFE by more than the permitted tolerances, the loan originator may cure the tolerance violation by reimbursing to the borrower the amount by which the tolerance was exceeded, at settlement or within 30 calendar days after settlement.

- Use of the revised GFE and the revised HUD-1 will be required as of January 1, 2010. During the transition period, the current RESPA requirements with respect to the GFE and the HUD-1 remain in effect, and settlement service providers may choose to proceed under either the current requirements for GFEs and HUD-1s or may choose to proceed under the requirements related to the revised GFEs and HUD-1s. Any settlement service provider who begins using the revised GFE prior to January 1, 2010, will be subject to all of the

Average Cost Pricing – Effective January 16, 2009

- The new rule establishes the following conditions under which any settlement service provider may use an "average charge" for any service provided to another settlement service provider:

  - o The average charge for any settlement service must be no more than the average amount paid for the settlement service by one settlement service provider to another settlement service provider on behalf of borrowers and sellers for a particular class of transactions involving loans subject to RESPA. The total amounts paid by borrowers and sellers for a settlement service based on the use of an average charge may not exceed the total amounts paid to the providers of that service for the particular class of transactions.

  - o In calculating its average charge, a settlement service provider must define the particular class of transactions as all transactions involving RESPA loans for:

    - * The period of time determined by the settlement service provider, but not less than 30 calendar days and not more than 6 months;

    - * The geographic area determined by the settlement service provider; and

    - * The type of loan determined by the settlement service provider.

  - o A settlement service provider may use an average charge in the same class of transactions for which the charge was calculated. If the settlement service provider uses the average charge for any transaction in the particular class, the settlement service provider must use the same average charge in every transaction within that class for which a GFE was provided.

  - o The use of an average charge is not permitted for any settlement service if the charge for the service is based on the loan amount or property value. For example, an average charge may not be used for transfer taxes, interest charges, reserves or escrow, or any type of insurance, including mortgage insurance, title insurance, or hazard insurance.

  - o If a settlement service provider uses an average charge, the provider must retain all documentation used to calculate the average charge for a particular class of transactions for at least 3 years after any settlement for which that average charge was used.

  The new rule provides that, if a settlement service provider violates any requirements regarding use of an average charge, the violation will be deemed to be a violation of section 4 of RESPA. An inadvertent or technical error in completing the HUD–1 shall not be deemed a violation of section 4 of RESPA if a revised HUD–1 is provided within 30 calendar days after settlement.

Limitations on Required Use of Affiliates – Effective January 16, 2009

- The new rule includes a revised definition of the term "required use." This revision is intended to clarify clear how this term will apply in the context of the affiliated business exemption provided in Section 8(c) of RESPA and HUD's related regulations, and frames the definition to apply to "persons" rather than only to "borrowers." The supplemental material included with the new rule states that this revised definition will not eliminate anyone's ability to offer legitimate consumer discounts, and that HUD does not interpret RESPA as preventing a settlement service provider or anyone else from offering a discount or other thing of value directly to the consumer. However, RESPA and this final rule limit tying such a discount to the use of an affiliated settlement service provider.

- Under the revised definition, in order to qualify for the affiliated business exemption, a settlement service provider may offer a combination of bona fide settlement services at a total price (net of the value of the associated discount, rebate, or other economic incentive) lower than the sum of the market prices of the individual settlement services and will not be found to have required the use of the settlement service providers as long as: (i) the use of any such combination is optional to the purchaser; and (ii) the lower price for the combination is not made up by higher costs elsewhere in the settlement process.

New Mortgage Servicing Transfer Disclosure – Effective January 16, 2009

- The format for the Servicing Disclosure Statement, which appears as Appendix MS–1 to the rules implementing RESPA, has been significantly simplified.

This summary provides only a very cursory overview of a very complex new rule. The additional guidance that HUD has committed to provide during the implementation period may help clarify fine points of this rule, but it is already clear that loan originators face an enormous task in updating their forms and procedures to comply with the sweeping changes HUD has mandated.

FAIL TO NOTIFY AT YOUR OWN RISK: INITIATION OF FORECLOSURE IS DEEMED AN "INCREASE IN HAZARD" UNDER INSURANCE CONTRACTS

By Allison E. Graves[1]

In a recent decision, the Tennessee Court of Appeals held that the commencement of foreclosure proceedings constitutes an "increase in hazard" under both the standard mortgage clause contained in an insurance policy and Tennessee Code § 56-7-804. This increase in hazard stems from the increased incentive an insured person has to burn down his or her home in an attempt to collect the insurance proceeds and pay off the debt on the house once he or she has knowledge of foreclosure proceedings. The failure to notify the insurer of such an increase in hazard is grounds for the invalidation of the insurance policy. *U.S. Bank, N.A. v. Tenn. Farmers Mut. Ins. Co.*, 2007 WL 4463959 (Tenn. Ct. App. Dec. 21, 2007).

U.S. Bank, N.A. ("U.S. Bank") held a mortgage on residential real estate owned by Jessica Robbins ("Robbins"). As required by the loan documents, Robbins obtained a Personal Fire and Extended Coverage Insurance Policy (the "Policy") from Tennessee Farmers Mutual Insurance Company ("Tennessee Farmers"). The Policy contained a standard mortgage clause (the "Clause"), which stated in relevant part:

> [Tennessee Farmers'] will:
> (a) protect the mortgagee's interest in the insured building. This protection will not be invalidated by any act or neglect of any insured person, breach of warranty, increase in hazard, change of ownership, or foreclosure if the mortgagee has no knowledge of these conditions; . . .
>
> [U.S. Bank] will:
> . . . (c) notify us of any change in ownership or occupancy or any increase in hazard of which the mortgagee has knowledge; . . .

U.S. Bank initiated foreclosure proceedings after Robbins defaulted on her mortgage. Robbins was notified of the foreclosure through letters sent to her by U.S. Bank and its attorney. Tennessee Farmers, however, was never given notice of the foreclosure proceedings. Shortly after Robbins received notice of the foreclosure, she filed a petition for bankruptcy under Chapter 13 of the Bankruptcy Code, which stayed the foreclosure proceedings. Approximately six months later, her house was destroyed by fire.

U.S. Bank subsequently submitted a claim to Tennessee Farmers under the insurance policy, which Tennessee Farmers refused to pay on the claim. Following this refusal, U.S. Bank filed a lawsuit against Tennessee Farmers alleging, among other things, breach of contract. U.S. Bank cited Tennessee

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Code § 56-7-804 (the "Statute"), in support of its claim that Tennessee Farmers could not refuse to pay U.S. Bank's claim based on the occurrence of foreclosure. The Statute contains almost identical language to the Clause. Tennessee Farmers argued that the Statute was inapplicable because U.S. Bank waived the protection of the Statute when it agreed to the provisions of the Policy. It further argued that the Clause required U.S. Bank to notify Tennessee Farmers of the initiation of foreclosure proceedings because it constituted an "increase in hazard," and U.S. Bank's failure to do so voided coverage under the Policy. U.S. Bank sought partial summary judgment as to the effect of the Statute. The trial court granted U.S. Bank's motion, and Tennessee Farmers appealed to the Tennessee Court of Appeals.

On appeal, the Court first found that the provisions of the Policy did not render the Statute inapplicable as Tennessee Farmers had contended. Thus, the Court examined both the Clause and the Statute to determine "whether Tennessee Farmers conclusively established as an affirmative defense that the foreclosure proceedings constituted an 'increase in hazard.'" *U.S. Bank*, 2007 WL 4463959, at *4. The Court concluded that both the Clause and the Statute require notice to an insurer of the initiation of foreclosure proceedings because such a proceeding *does* constitute an "increase in hazard."

In interpreting the language contained in the Clause, the Court noted that a split in authority exists as to whether the initiation of foreclosure proceedings constitutes an increase in hazard. The Court rejected the rationale adopted in some jurisdictions that it cannot be presumed that the initiation of foreclosure proceedings presents such an increase in hazard that the failure to notify the insurer of such invalidates the insurance policy. It further rejected the idea that the "increase in hazard" contemplated by an insurance policy means only a physical condition that would make the risk more hazardous. The Court instead adopted the reasoning of those courts that have found that the commencement of foreclosure proceedings creates a "well-recognized increase in hazard." *Id.* at *6. This increase in hazard is precipitated by the insured's knowledge of the foreclosure proceedings because "it gives the financially delinquent insured incentive to destroy the house intentionally to receive the proceeds of the insurance policy to apply against his debt." *Id.* at *9 (citation omitted).

The Court reached the same conclusion with respect to the Statute. It recognized that two prior Tennessee cases have held that an insurance policy cannot be invalidated for failure to notify the insurer of foreclosure proceedings. However, the Court found that neither was directly applicable to this case because one was decided before the Statute was enacted and the other did not directly address the issue of whether the initiation of foreclosure proceedings constituted an increase in hazard under the Statute. Because the prior cases were not applicable, the Court adopted the same rationale that it used in interpreting the Clause; namely, that the knowledge of the initiation of foreclosure proceedings by the insured creates a well-recognized increase in hazard because it gives incentive to an insured to burn down his or her house for the insurance proceeds.

As a result, the Court held that U.S. Bank had a duty under both the Clause and the Statute to notify Tennessee Farmers of the foreclosure proceedings at the time it notified Robbins of the same because the notification to Robbins created an increase in hazard. Failure to do so invalidated the Policy since U.S. Bank had knowledge of an increase in hazard of which it failed to notify Tennessee Farmers.

The Tennessee Supreme Court granted a Writ of Appeal for this case in May 2008. The author will be following the progress of this case and providing updates as appropriate.

Well Grounded: A well-drafted provision for future rent adjustments is critical in the negotiation of a ground lease

By Lawrence Teplin and Heather Stern*

Like a bride and groom who vow to keep the bonds of marriage together "till death do us part," a landlord and tenant who enter into a ground lease make a long-term commitment to each other. However, in a ground lease contract, the economics of the deal, rather than love, form the consideration. At the outset, the parties must agree that the relationship will bring value to both sides over its term regardless of good times or bad and that each will treat the other fairly to ensure their relationship will endure.

As often occurs in marriages, however, money can become a source of conflict. In the context of a ground lease, the parties must agree to a rent that will be paid over decades and adjusted under economic or financial circumstances that will almost invariably differ from what at least one, if not both, parties expected when they first entered into the lease. If the ground lease is not well drafted, there is a greater likelihood that the parties will find themselves in litigation—the commercial equivalent of divorce.

To avoid this eventuality, a landlord and tenant must give careful attention to negotiating and drafting the ground lease provisions that govern future rent. Critical to these provisions is not only the rent adjustment mechanism (which usually calls for an appraiser to be appointed and to then determine the fair market value of the fee property by applying an agreed-upon formula) but also the alternative dispute resolution (ADR) procedures often intricately woven into the rent adjustment mechanism. The more clearly the mechanism is drafted, the less chance that a dispute will arise in the first place. If one does occur, the enforceable ADR provisions may prevent the dispute from destroying the relationship altogether.

A ground lease is an instrument by which a fee owner leases real property to a tenant for an extended term lasting anywhere from 20 to 100 years. The tenant typically intends to develop the property by constructing improvements or renovating existing facilities.[1] Commercial ground leases are frequently used for office buildings, shopping centers, hotels, and other commercial projects.

Ground leases are also present in residential projects in which, for example, the land is owned by a government entity (such as the land Los Angeles County owns in Marina del Rey) or a Native American tribe (as certain home development sites are in the Palm Springs area).

Because of the extended term, the parties to a ground lease face a unique problem. From the landlord's perspective, the rent terms must be structured so that decades later the rental income will provide a reasonable return. From the tenant's perspective, the future rent must bear

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1 JEROME D. WHALEN, COMMERCIAL GROUND LEASES 1 (1988).

a reasonable relationship to the income-producing ability of the improvements that the tenant has constructed to service the debt or other financing.[2] In other words, both parties have to be assured that the economics of the lease will still work decades in the future and that each party will be treated fairly if, as is likely, the economic assumptions underlying the deal change.

The Rent Adjustment Mechanism

Given these circumstances, one of the most highly negotiated, if not litigated, sections in a ground lease is the mechanism for adjusting rent and resolving any disputes related to the rent. The goal of this section of the lease should be twofold. First, it should clearly and comprehensively detail the parties' agreement as to how rent will be adjusted in a manner that will be capable of being understood and implemented over the entire lease term. In addition, the parties must agree to be bound to a cost-effective and efficient means of resolving any dispute that does arise concerning future rent.

A formula that relies on the fair market value of the land and/or the improvements at some specified date in the future, and then applies a percentage of that value is one means of setting future rent. As an example, a commercial ground lease might state the following:

> For the initial 10-year period commencing January 1, 2007, the annual rent shall be $20,000 per year. For the remaining term the annual rent shall be set every 10 years based on an amount equal to five percent of the fair market value of the leased land fixed as hereinafter provided.[3]

Another, but less prevalent, method of calculating future rent is to set rent at the fair rental value of the property based on either the land or the land and a percentage of the building.

To determine fair market value (which is then used as the input into the rent adjustment formula) or fair rental value, a lease typically includes a form of alternative dispute resolution by providing for appointment of an appraiser (or panel of appraisers) who serves as the neutral arbitrator. The appraiser or arbitrator is empowered to enter a determination of value that is binding on all parties. By including this mechanism, a landlord and tenant can ensure that a fair process is available to adjust the rent at any time during the lease term. Further, because this process constitutes an enforceable arbitration provision, it includes all the benefits of arbitration, including cost efficiency and finality.

In addressing the appointment of an appraiser or panel of appraisers, a lease should set forth, at a minimum, the parties' agreement on the following critical terms: 1) the number of appraisers to be appointed, 2) the required qualifications, if any, of the appraisers, 3) who will appoint the appraisers and by what process, 4) who pays for the appraisers, 5) who is bound by the appraisers' determination of value, 6) the method of appraisal, if any, that must be followed, and 7) the specific assignment that the appraisers must complete, including the date and subject

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2 *Id.* at 4.

3 *See, e.g., Bullock's, Inc. v. Security-First Nat'l Bank*, 160 Cal. App. 2d 277, 279 n.l (1958). In this example, or any other, the key negotiated items are the resetting term and the percentage of value to be used (which of course, could change at each term).

of valuation. Because many of these terms will depend on the specific type of property being appraised and the type of appraisal that would best serve the client's interests, counsel for the landlord and tenant may each find it worthwhile to engage an appraiser to assist in drafting and negotiating these key terms.

While the number of appraisers is frequently set according to the method followed in appointing the appraisers, certain observations can be made. The advantages of selecting one appraiser are the cost savings and efficiency that follow from having one final arbiter of value. The disadvantage of leaving value in the hands of one person—and the advantage of a panel of appraisers (recognizing that a panel will always be more expensive and take more time to render a determination of value)—is that the parties are trusting their future economic relationship to a single person who may make a mistake or be biased. This is particularly risky because an appraiser acting in this capacity is deemed by law to be an arbitrator whose decision is effectively final.[4]

To ameliorate this concern, the parties will frequently agree that the appraiser (or panel of appraisers) must have certain qualifications. The assumption is that the more qualified the appraiser is, the less likely that individual will make a mistake or allow bias to interfere with making an objective determination of value. These qualifications may include having a certain number of years of experience as an appraiser, especially in valuing the particular property at issue, and being a Member of the Appraisal Institute (MAI). In specifying qualifications, however, the parties should not overlook the potential number of appraisers who will be able to satisfy these criteria when the time comes to appoint an appraiser (or panel of appraisers). The parties could find themselves in the future in the ironic situation of having imposed so many qualifications that few, if any, appraisers can meet the criteria imposed by the lease, thus leading a court to appoint an entirely unqualified appraiser based on a finding that the appraisal provision as drafted has "failed" or "cannot be followed."[5]

One common requirement is that the appraisers be neutral. In imposing such a requirement, the parties should be aware that, in California, by statute, a neutral arbitrator is one "who is 1) selected jointly by the parties or by the arbitrators selected by the parties or 2) appointed by the court when the parties or the arbitrators selected by the parties fail to select an arbitrator who was to be selected jointly by them."[6] Other states may have similar statutory provisions. If the parties wish to impose any other qualification, they should make their intentions known in the lease.

A landlord and tenant can also specify the method of appraisal. For example, they can agree that the appraiser must determine value through one or more of the following methods: comparable rentals, return on investment, or residual value. However, even if a landlord and tenant do not specify the method of appraisal, they should certainly provide as much detailed guidance as possible as to what valuation the appraiser is expected to provide and when. An

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4 *See, e.g.,* CAL. CODE CIV. PROC. §1280(a); *Moncharsch v. Healy & Blase*, 3 Cal. 4th 1, 10 (1992) ("The arbitrator's decision should be the end, not the beginning, of the dispute.").

5 *See, e.g.,* CAL. CODE CIV. PROC. §1281.6.

6 CAL. CODE CIV. PROC. §1280(d).

appraiser is often asked to determine "fair market value"[7] or "fair rental value," but leases often neglect to guide the appraiser as to what this determination is to be based on. For example, is the appraiser determining the fair market or rental value of the land by itself without any improvements? The land with certain specified improvements? The building? The leasehold premises? The property description should be as specific as possible.[8] In addition, the lease should specify whether fair market or rental value is being determined at the property's "highest and best use," as the property is then currently being used, or as the parties contemplate the property to be used in the future.[9] It is also critical that the lease designate the date of value, which is typically the date that the adjusted rent first takes effect.

Appointment of the Appraisers

The decisive factor in resolving many of the issues associated with defining the rent adjustment mechanism—including the number of appraisers and their qualifications—is the provision that defines who will appoint the appraisers and set the appointment process. Who appoints the appraisers may seem obvious—presumably, it will be the parties to the lease. However, the obvious answer may not always be the appropriate one. For example, if a landlord enters into a lease with two individual partners as tenants, a provision giving each individual party a right to participate in the appointment process would result in the tenants having an inherent numerical advantage over the landlord. The tenants would then want to use their majority "vote" to obtain a low valuation of fair market value, to the disadvantage of the landlord, who would be seeking a high valuation. In these situations, the landlord and tenants should agree that each group having a common interest will designate one individual to represent that group in deciding who will be appointed as the appraiser. Doing so will eliminate any unfair advantage that a group with multiple parties could gain by participating individually in this process rather than collectively.[10]

Landlords and tenants have several options for appointing appraisers through a fair process and, hopefully, thereby obtaining a fair result. The following are five different procedures prevalent in commercial ground leases and the advantages and disadvantages of each:

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7 While an agreement that the appraiser will determine "value" has been held in at least one case to refer to "fair market value," to avoid any dispute over the interpretation of the agreement, the lease should specify "fair market value" (unless some other value, such as "use value" or "rental value," is intended). *Bullock's*, 160 Cal. App. 2d at 281-82. *See also Eltinge & Graziadio Dev. Co. v. Childs*, 49 Cal. App. 3d 294, 298-99 (1975).

8 This issue particularly becomes critical when, decades in the future, new laws or ordinances are enacted that restrict the development of the real property. The tenant, desiring a lower rent, will insist that the restrictions be taken into account in any appraisal of the highest and best use of the land. The landlord, desiring a higher rent, will insist that the land be valued without regard to the improvements, including without regard to the negative impact of those improvements on the otherwise highest and best use of the land. *See, e.g.*, *Humphries Invs., Inc. v. Walsh*, 202 Cal. App. 3d 766, 770-73 (1988).

9 For example, in a case in which a lease specified that the adjusted rent should be based on the fair market rental value of a theater building, the court found that the appraiser could not consider the potential highest and best use to the landlord as a retail shopping center. *Wu v. Interstate Consol. Indus.*, 226 Cal. App. 3d 1511, 1517 (1991).

10 For an example of a dispute that arose when an agreement called for the appointment of an arbitrator by each of the parties to the agreement, as opposed to each of the aligned "sides," *see Tate v. Saratoga Sav. & Loan Assn.*, 216 Cal. App. 3d 843, 852 (1989).

1) Each party or side selects one appraiser, and the two appraisers meet and confer to select a third, neutral appraiser. The third, neutral appraiser is then charged with the responsibility of determining value under the lease. The advantage of this method is that it is bilateral, and if it works, it is efficient and perceived as fair by both sides. However, the disadvantage is that it often does not work because the two appraisers are unable to reach agreement on the third appraiser. When this occurs, the parties have to petition a court to appoint the third appraiser on the ground that the method set forth in the lease has failed or cannot be followed.[11] Accordingly, if the parties want to use this method, they should be comfortable with the statutory procedure that a court will follow in this eventuality.

2) Under the "baseball" method, each party selects an appraiser. Each appraiser arrives at a reasoned, supportable conclusion of value and then they mutually agree to the appointment of a third, neutral appraiser. This appraiser is provided with the two different valuations and then must make a binding selection as to which of the two appraisals most closely approximates the true value. The advantage in this option is that both parties are active participants in the process. However, this method is more costly to both parties and less efficient because it calls for multiple appraisers to each determine the property's value. This method can also result in a finding of value that lies at an extreme, because the third, neutral appraiser must accept one of the conclusions provided by the party-appointed appraisers. This method also suffers from the same disadvantage as the first option if the two appraisers are unable to agree on the designation of the third, neutral appraiser.

3) In the "appraiser average method," each party selects an appraiser who conducts an appraisal according to the requirements of the lease. If the two appraisers are unable to agree on a determination of fair market rent, they must together pick a third appraiser who conducts his or her own appraisal. If a majority of the three appraisers cannot agree on fair market rent, the three appraisals are averaged together, and the average is binding on the parties. A variation of this method is that the parties agree to disregard any low or high appraisal that varies by more than 10 percent from the middle appraisal before averaging the results. This option, too, has the advantage of actively involving the parties, while its disadvantage is that it will not avoid litigation if the two appraisers are unable to agree on a third appraiser. This method can also be more expensive, not only for this latter reason, but also because up to three different appraisals may have to be conducted.

4) The landlord is granted the power to unilaterally adjust the rent after engaging an appraiser who meets certain qualifications and determines fair market value. If the tenant disagrees with that value, the tenant has the right to demand arbitration of the issue within a prescribed time. The arbitration can follow one of the appraisal methods described above, or a standard arbitration clause can be applied whereby the arbitrator (usually a judge or real estate lawyer) hears testimony and argument and then renders findings of fact and conclusions of law binding on the parties. Some clients are more comfortable with the "private judge" approach because it involves a familiar, adversarial process,

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[11] *See, e.g.*, CAL. CODE CIV. PROC. §1281.6.

similar to a judicial action, in which they can be assured that, at a minimum, their arguments will be heard. The disadvantage is that this dispute resolution mechanism is potentially much more expensive because the client will have to pay not only for the appraisal but also for the lawyers and arbitrators involved in the dispute.

5) The parties do not directly appoint the appraiser (or panel of appraisers) but place their fate directly in the hands of others by agreeing that the appraisers will be appointed by a court under the statutory procedures in place at the time of the dispute. The advantage of this mechanism, in the minds of some parties, is the belief that they will get a fair result from a court in a relatively short amount of time without having to endure a back-and-forth process in what may be a futile attempt to try to agree on an appraiser without court intervention. The disadvantage is that the parties lose the ability to control the appraiser-appointment process on their own, without court intervention, and instead may be stuck—as a first resort, not as a last resort—with an unfavorable appointment by the court.

Appraisal versus Arbitration

Under California law, an appraiser empowered to make a final determination of value binding on the parties is deemed to be an arbitrator.[12] This is significant because appraisers appointed to determine value under commercial ground leases are generally held to the same statutory requirements as those governing arbitrators, such as disclosure rules on conflicts of interest. Unless the lease clearly states otherwise, however, an appraiser appointed to determine value is not required to hold hearings, make evidentiary rulings, hear testimony, and render findings of fact and conclusions of law.

The law distinguishes between an appraiser acting as an appraiser (whose finding of value is binding like an arbitration award) and an appraiser acting as an arbitrator. In the former case, the duly appointed appraiser (or panel of arbitrators) does his or her own investigation and appraises the property—following the guidelines set out in the lease and mandated by the industry—just as the appraiser would if a party hired him or her to prepare an appraisal to obtain a loan or acquire or dispose of property.[13] In the latter case, the duly appointed appraiser (or panel of appraisers) holds court like an arbitrator or judge in an eminent domain action, which includes receiving evidence from experts, hearing argument, and rendering findings of fact and conclusions of law.

While this distinction is recognized legally, the parties should nevertheless leave no doubt in the lease as to the role of the appraisers. For example, the parties should carefully consider any broad language empowering the appraiser to resolve "all disputes" between the parties. Although the parties may feel comfortable leaving a dispute concerning value in the hands of an appraiser, the parties would likely not want that same person determining complex

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[12] CAL. CODE CIV PROC. §1280(a). *See also Michael v. Aetna Life & Cas. Ins. Co.*, 88 Cal. App. 4th 925, 934 (2001) ("An agreement providing for an appraisal is...considered to be an arbitration agreement subject to statutory contractual arbitration law in the California Arbitration Act.").

[13] For cases that have discussed the differences between these two types of appraisal ADR provisions, *see Bewick v. Mecham*, 26 Cal. 2d 92 (1945); *Coopers & Lybrand v. Superior Court*, 212 Cal. App. 3d 524, 535 (1989).

legal issues such as interpreting ground lease terms or the parties' intentions at the time at which they entered into the lease.[14]

In drafting a rent adjustment mechanism and accompanying ADR provision in a long-term lease, the parties should be familiar with the statutes governing arbitration in the relevant jurisdiction. This will enable the parties to be aware of certain key issues, such as what happens if the method of appointing the appraiser set forth in the lease fails or cannot be followed,[15] what disclosures they are entitled to receive regarding ethical conflicts that a proposed appraiser may have,[16] and the procedure and grounds for disqualifying an appointed appraiser.[17]

As an example, in California, when the method of appointing an appraiser under a lease has failed or cannot be followed, there is a relatively simple, express statutory procedure (sometimes referred to as the "five-pack") governing the appraiser-appointment process. The process begins with one party filing a petition with a court for appointment of an appraiser and obtaining a hearing date. In the briefing, each party proposes five appraisers to the court (sometimes more, sometimes less), and the court ultimately nominates five appraisers from among all the proposed appraisers. On receiving the court's nominations, the parties meet and confer to determine if they can agree to an appraiser from among the court's list of five. If no agreement is reached, then the court selects one. Since a neutral arbitrator—which includes an appraiser selected under this method—can be disqualified on the same grounds as a judge, a party may exercise its peremptory challenge to disqualify the court's choice of appraiser much as a judge can be removed by a Code of Civil Procedure Section 170.6 motion.[18] The court will then nominate a second appraiser who is also subject to challenge by the other party. If this occurs, the court nominates a third appraiser who cannot be disqualified except for cause. Assuming the third appraiser satisfies legally mandated disclosure requirements and is not otherwise subject to disqualification for cause,[19] the parties will finally have an appraiser.

The same level of careful thought and drafting that is given to the appraisal process provisions should, of course, be applied to the entire ground lease. For example, recitals should be written to make clear the parties' intent in entering into the lease,[20] other lease terms should be drafted with precision, and other provisions should be drafted to avoid any dispute over

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[14] While issues such as whether the parties agreed in the first place to arbitrate the particular dispute are generally decided by the court and not the arbitrator, the parties can agree to have these issues determined by the arbitrator. *See, e.g., Freeman v. State Farm Mut. Auto. Ins. Co.*, 14 Cal. 3d 473, 480 (1975) ("It is, of course, possible for the parties to agree that the arbitrator may determine the scope of his authority. 'The arbitrability of a dispute may itself be subject to arbitration if the parties have so provided in their contract.'"(quoting *McCarroll v. Los Angeles County Carpenters*, 49 Cal. 2d 45, 65 (1957)).

[15] *See, e.g.*, CAL. CODE CIV. PROC. §1281.6.

[16] *See, e.g.*, CAL. CODE CIV. PROC. §1281.9.

[17] *See, e.g.*, CAL. CODE CIV. PROC. §1281.91.

[18] *Id*.

[19] CAL. CODE CIV. PROC. §§1281.9, 1281.91.

[20] The use of recitals to establish the intent of the parties can be particularly important with a ground lease, given that the extended term of the ground lease means that at the time of a dispute, it will likely be very difficult to garner evidence about the original "intent" of the parties, other than the language of the contract itself. Of course, the intent of the parties is critical to contract interpretation. *See, e.g.*, CAL. CIV. CODE §1636; *Oberg v. City of Los Angeles*, 132 Cal. App. 2d 151, 158 (1955) ("In construing a contract, the primary object is to ascertain and give effect to the intention of the parties as it existed at the time of contracting.").

conscionability.[21] By following these principles, a landlord and tenant can achieve their mutual objective of establishing a fair process that can help them each achieve their economic objectives, avoid lease disputes, and preserve the long-term viability of their relationship.

[21] Among the conscionability guidelines is the idea that the appraisal appointment mechanism should be bilateral, allowing each party to participate in the appointment of an appraiser. *See, e.g.*, *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 825 (1981); *Sehulster Tunnels/Pre-Con v. Traylor Brothers, Inc./Obayashi Corp.*, 111 Cal. App. 4th 1328, 1341 (2003). As the court said in *Graham*: "A well-recognized principle of 'natural justice'...is that a man may not be a judge in his own cause." *Graham*, 28 Cal. 3d at 824 (quoting *Matter of Cross & Brown Company*, 4 App. Div. 2d 501 (N.Y. 1957)).

Legal Opinions in Real Estate Transactions Committee update for RPTE E-Report

The Legal Opinions in Real Estate Transactions Committee ("Committee") approved the "Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions" (the "Statement") that was advanced by, among others, the ABA's Business Law Section. The Statement has been approved by a large number of bar associations and professional groups. The Committee and other proponents of the Statement believe that a succinct paper regarding the role of customary practice in legal opinion practice will provide useful guidance to those endeavoring to understand the diligence required to provide legal opinions as well as the meanings of many of the words used in legal opinions.

The Committee is currently engaged in a project to develop an annotated form of legal opinion. The initial premise of the project is to review the "Inclusive Real Estate Transaction Opinion" (the "All-Inclusive Opinion") and to provide annotations and references to bar association reports as well as practice commentary on certain of the aspects of the All-Inclusive Opinion.

Members of the Committee have been involved in the Working Group on Legal Opinions (WGLO). The WGLO is an endeavor to bring together various legal opinion constituencies to address third-party legal opinion issues and has, to date, sponsored five conferences dealing with legal opinion issues. The most recent WGLO conference was held on October 27, 2008 in New York. The October 27, 2008 WGLO conference included programs entitled, "Status of Customary Practice Report," "Structured Finance Opinions," "Boilerplate Exceptions," "Ethical Considerations in Opinion Giving," "Legal Opinion Education," and Multi-Investor Deal Opinions." That conference also had breakout sessions (each with a limited group of participants) entitled, "When Not to Request or Give a Third-Party Legal Opinion," "Structured Finance: Way of the Future," "Bring-Down Opinions," "The Procedural Aspect of Opinions: Can You (Should You) Do Anything About It," "Legal Opinion Education," "Incorporation by Reference," and "Inadvertent Opinions." The next WGLO conference is tentatively scheduled for May 18, 2009 in New York.

The Committee chair is Kenneth M. Jacobson (kenneth.jacobson@kattenlaw.com). The Committee vice-chairs are Edward J. Levin (edward.levin@dlapiper.com) and R. Gibson Masters (gib.masters@klgates.com).

The Committee encourages your involvement. If you are interested in getting involved with the Committee, you should contact the Committee chair or either of the vice-chairs.