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RP Article

SEVENTH CIRCUIT CLARIFIES ENFORCEABILITY OF YIELD MAINTENANCE CLAUSE IN *RIVER EAST*

In September, 2006, a federal district court in Illinois held that a prepayment fee[1] calculated using a yield maintenance formula was an unenforceable pena The case is *River East Plaza, L.L.C. v. The Variable Annuity Life Insurance Company*, 2006 WL 2787483 (N.D. Ill., Sept. 22, 2006). The United States Court of A for the Seventh Circuit recently reversed this holding and held that the fee as calculated using the yield maintenance formula was enforceable.[2]

FACTS

In 1999 Variable Annuity Life Insurance Company made a loan in the original principal amount of $12,700,000. The term of the loan was twenty years. Th provided that the loan could only be prepaid if the borrower paid a prepayment fee. The prepayment fee was the greater of (a) one percent of the principal balance the difference between the discounted present value of the remaining payments of principal and interest and the outstanding amount of principal. The discount to p value was based on the rate of United States Treasury bonds or notes with maturity dates the same as the maturity date of the loan. The rates were determined as of date that the borrower gave its notice of intent to prepay. This is a standard yield-maintenance clause.[3] Three years later, in 2002, the borrower had an opportunit sell the property and wanted to pay off the loan in connection with the sale. The borrower requested a payoff from the lender. The lender calculated the amount of prepayment fee at approximately $4,713,000, or thirty-eight percent of the principal balance.[4] The borrower paid the fee under protest and then brought an action state court for a declaratory judgment that the prepayment fee was an unenforceable penalty.

DISTRICT COURT DECISION

The lender removed the case to the United States District Court for the Northern District of Illinois which held that the prepayment fee as calculated using th yield maintenance formula was an unenforceable penalty. According to the district court, Illinois law, which governed in this diversity case, uses a liquidated dama analysis to determine whether a prepayment provision is a penalty. Under a liquidated damages analysis, among other things, the amount of damages must be reaso at the time of contracting. The district court determined that the yield maintenance calculation in the River East note was not reasonable because the amount of the prepayment fee calculated using the yield maintenance formula did not bear a relationship to the damages that the lender sustained as a result of the prepayment. T district court wrote that the prepayment provision should represent the present value of the lost interest if the lender reinvests the principal in a comparable real esta investment. The Treasury rate used in the yield maintenance calculation was much lower than the rate of a comparable commercial real estate loan at the time of th prepayment, making the prepayment fee artificially high. This calculation overcompensates the lender, according to the district court.[5] The borrower showed evi suggesting that the lender in fact did not invest the money that was prepaid in treasuries, but put it in higher yielding investments. The district court held that the le was entitled only to the alternative one percent prepayment fee.[6]

SEVENTH CIRCUIT OPINION

The lender appealed the district court's decision to the Seventh Circuit Court of Appeals. In a decision dated August 22, 2007 and reported at 2007 WL 237' the Seventh Circuit reversed the district court's decision. The Seventh Circuit noted that since the Illinois Supreme Court had not addressed the enforceability of a prepayment fee in a commercial mortgage, the Seventh Circuit would have to make an *Erie* guess about how the Illinois Supreme Court would rule in this question. borrower argued that an Illinois court would analyze the prepayment fee under a liquidated damages analysis. The lender argued that under Illinois law, the prepay clause would be considered to be a bargained-for form of alternative performance and not as liquidated damages. The Seventh Circuit noted that an Illinois case hac specifically cited the second sentence of Section 356 of the Restatement (Second) of Contracts,[7] a traditional liquidated damages test,[8] which provides, "A term unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty." The Seventh Circuit observed that penalty clauses are distinguis from alternative forms of performing obligations. Comment c to Section 356 provides in part, "In determining whether a contract is one for alternative performance relative value of the alternatives may be decisive." The court then considered the relative values of the prepayment provision in the River East note. The value to t borrower was clear: by paying off the loan early, the borrower paid only $3.9 million in interest, rather than the $13 million that the borrower would have paid over term of the note if the borrower had not prepaid. The benefit to the lender was that the lender received its principal and had the choice to invest in Treasuries or re- the money in another investment with a higher return and higher risk. Since the alternative performances for both the borrower and lender had value, reasoned the Seventh Circuit, the prepayment provision was not a penalty but was a bargained-for alternative means of performance and was therefore enforceable. The Sevent Circuit held that the lender was entitled to judgment as a matter of law on the question of the enforceability of the prepayment provision, and reversed the district co this issue. The Seventh Circuit noted that an issue remained regarding the calculation of the amount of the prepayment charge, and remanded the case to the distric for further proceedings on this issue.

ANALYSIS

There are several interesting issues in the Seventh Circuit's decision. First, it is interesting to note that, while the district court considered the fact that the le arguably benefited from the prepayment as a reason why the yield maintenance provision was an unenforceable penalty, the Seventh Circuit considered the lender's potential ability to make a better investment as a bargained-for alternative performance and therefore the basis for finding that this prepayment provision was not a penalty.

Second, while the Seventh Circuit began its analysis by following the borrower's argument that a liquidated damages analysis should govern, this inquiry q morphed into following the lender's argument that the test should be whether the prepayment clause represents bargained-for alternative performance. The transitic point from the borrower's test to the lender's test was comment c to Section 356 of the Restatement, which comment provides that a contract provision may not be a penalty if both parties benefit from the alternative performance. Based on the court's conclusion that the yield maintenance clause was not a penalty because the cl had value to both parties, the Seventh Circuit arguably adopted the lender's suggested test for determining the enforceability of the clause rather than the borrower's

Third, while the Seventh Circuit went through the liquidated damages analysis because of the possibility that an Illinois court would apply a liquidated dama analysis, the court questioned whether a liquidated damages analysis was an appropriate test for a voluntary prepayment.[9] Prepayments can be voluntary, such as a borrower decides to sell the property (as was the case in *River East*) or when the borrower refinances, or involuntary, such as when the borrower defaults. Arguat liquidated damages analysis should only apply when there is a breach of the contract, not when the borrower chooses to exercise a contractual alternative.[10] The Seventh Circuit quoted at length from an article by Professor Dale Whitman to the effect that a liquidated damages analysis should not apply to voluntary prepayme [11] When a lender seeks to enforce a prepayment provision in bankruptcy, Section 506(b) of the Bankruptcy Code imposes a reasonableness limitation on the enforceability of prepayments fees, regardless of whether the payment is voluntary or involuntary.[12]

Finally, this case is one of several recent federal court cases upholding the enforceability of yield maintenance clauses. Since the district court decision in *R East*, the Eighth Circuit Court of Appeals has affirmed a district court decision enforcing a prepayment fee with a yield maintenance provision[13] and a federal districtcourt in Ohio has held that a prepayment fee based on a yield maintenance formula was enforceable.[14] It is important to remember that these cases are all courts in diversity cases predicting how state courts would rule. State courts could reach different results. The last paragraph of the opinion dealing with the questi the enforceability of the prepayment charge suggests that the Seventh Circuit was aware of its role with regard to state law issues:

> We are convinced that a contrary result would have broad implications for both lenders and borrowers of mortgage-secured loans in Illinois, and might inadvertently effect a wide-ranging alteration of the law of real estate financing in Illinois. "The responsibility for making innovations in the common law of Illinois rests with the courts of Illinois, and not with the federal courts." [citations omitted]

PRACTICAL LESSONS

What practical lessons can attorneys learn about yield maintenance provisions from the *River East* case?

For attorneys representing lenders, don't use language that the prepayment provision constitutes liquidated damages. Consider instead including in the note loan agreement recitals to the effect that (if applicable) the lender is making long-term financial commitments to third parties based on receiving the payments nego in this agreement; that the lender's financial performance and ability to meet its commitments depend not just on total returns from loan but timely payment on the negotiated; that if the borrower prepays, the lender will have redeploy the funds and may not be able to achieve the same level of return in the market, and that this maintenance clause was specifically intended by borrower and lender to protect the lender against this risk; that borrower acknowledges that lender could have proh prepayment altogether or borrower could have negotiated different prepayment terms, but that in that event the interest rate would have been higher to compensate lender for this risk; that lender is not required to actually invest the funds in US Treasuries; and that the calculation of the prepayment charge using a yield mainten clause is bargained-for consideration and does not represent damages or a penalty. The lender also may want to provide the borrower with some examples of how t yield maintenance provisions would work. Lenders who are seeking to enforce prepayments based on yield maintenance formulas in court need to be prepared to h expert testify about how the yield maintenance formula was calculated.[15]

For attorneys representing borrowers, the most important lesson is understanding that yield maintenance clauses like the one in *River East* can produce astronomical numbers and advising the client about this. Borrowers are often focused on the interest rate and the non-recourse provisions, and the terms of the prepayment provision often are beneath their radar, so it would be prudent to document this advice. The borrower's attorney needs to understand the prepayment provision and try to negotiate the best terms that he can for his client.[16] Depending on whether the law in his or her state is settled, the borrower's attorney shoul an exception in his enforceability opinion for the enforceability of the prepayment provisions. Finally, if matters reach a point that the lender is making demand fo payment of the prepayment penalty, the borrower's attorney should be sure to check the lender's calculations. In the *River East* case, the lender overstated the prepayment fee by almost a million dollars.

CONCLUSION

The Seventh Circuit's decision in *River East* is an important decision regarding the enforceability of prepayment provisions in general and yield maintenanc calculations specifically. It contains important lessons for lenders and borrowers.

[1] For detailed analysis of the law of regarding prepayment fees generally, see John C. Murray, *Enforceability of Prepayment-Premium Provisions in Mortgag Documents*, John C. Murray Reference Library, http://www.firstam.com/ekcms/uploadedFiles/firstam_com/References/Reference_Articles/John_C_Murray_Reference/Mortgages_and_Financing/prepaymentartic menu=682 (last visited on October 22, 2007); Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 U.C.L.A. L. Rev. 851 (April 1993).

[2] *River East Plaza, L.L.C. v. The Variable Annuity Life Ins. Co.*, 2007 WL 2377383 (7th Cir., Aug. 22, 2007).

[3] For background on the use of yield maintenance clauses to calculate prepayment charges, *see* George Lefcoe, *Yield Maintenance and Defeasance: Two Dist Paths to Commercial Mortgage Prepayment*, 28 Real Est. L.J. 202 (Winter 2000).

[4] Negotiations continued between the lender and the borrower over the date of prepayment and the calculation of the prepayment. Eventually the lender cred borrower $826,922.27 as a result of errors in the lender's calculations.

[5] At trial the borrower introduced testimony of the lender's Director of Mortgage Loans that the prepayment calculation in the note was "very, very punitive." district court quoted this testimony twice in its opinion. One article has suggested that these comments were made in an unrelated proceeding in a different ma Gregory A. Thorpe, *River East Plaza: Liquidated Damages Analysis Applies to Prepayment Premium,* 42 Real Prop. Prob. & Trust J. 41, 45 n. 20 (Spring 200

[6] The district court extensively cited *In Re Kroh Bros.*, 88 B.R. 997 (Bankr. W.D. Mo. 1988) and *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987) in s of its holding. These cases have been heavily criticized. *See* John C. Murray, *Prepayment Premiums: A Bankruptcy Court Analysis of Reasonableness and Liquidated Damages,* 105 Com. L.J. 217, 228 (2000); Debra P. Stark, *New Developments in Enforcing Prepayment Charges After an Acceleration of a Mortag Loan*, 26 Real Prop. Prob. & Trust J. 213 (1991).

[7] The first sentence of Section 356 of the Restatement (Second) of Contracts states: “Damages for breach by either party may be liquidated in the agreement b only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.”

[8] An alternative statement of the test for liquidated damages is found in the Uniform Commercial Code. Section 2-718(1) of the uniform version of the Unifor Commercial Code provides in relevant part:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

In 2003 the National Conference of Commissioners of Uniform State Laws and the American Law Institute proposed amendments to Section 2-718(1) that wo make a distinction between commercial and consumer loans. These amendments, among other things, inserted the words "and, in a consumer contract," in the sentence of Section 2-718(1), so that the first sentence would read, "Damages for breach by either party may be liquidated in the agreement but only at an amo that is reasonable in the light of the anticipated or actual harm caused by the breach, and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy." The 2003 amendments also drop the last sentence of Section 2-718(1), which pro "A term fixing unreasonably large liquidated damages is void as a penalty." However, no state has adopted the 2003 amendments to Article 2.

[9] One author has taken the position that the district court’s opinion that Illinois law requires a liquidated damages analysis of prepayment provision is not a co interpretation of Illinois law. Gregory A. Thorpe, *River East Plaza Liquidated Damages Analysis Applies to Prepayment Premium*, 42 Real Prop. Prob. & Tru 41, 51-55 (Spring 2007).

[10] *See Clean Harbors, Inc. v. John Hancock Life Ins. Co*., 833 N.E. 2d 611, 618 (Mass. App. 2005).

[11] Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 U.C.L.A. L. Rev. 851 (April 1993).

[12] Section 506(b) of the Bankruptcy Code provides,

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

This statute applies to prepayment fees. *See Holmes v. Citigroup Investments AgriFinance (In re Holmes),* B.R. 317, 321 (Bankr. M.D. Ga. 2005); *In re Outdo Sports Headquarters, Inc.,* 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993). The First Circuit has recently held that when the debtor’s assets exceed the claims of creditors, a secured creditor who cannot meet the reasonableness test of Section 506(b) nevertheless may be able to collect its prepayment fee under Section 5 the Bankruptcy Code. *Gencarelli v. UPS Capital Business Credit*, 2007 WL 2446883 (1st Cir., Aug. 30, 2007).

[13] *CP Holdings, Inc. v. California Public Employees Retirement System*, 2006 WL 3203751 (8th Cir., Nov. 7, 2006).

[14] *Chillicothe Telephone Co. v. The Variable Annuity Life Insurance Co.*, 2007 WL 397058 (S.D. Ohio, Jan. 31, 2007).

[15] In prepayment cases the outcome sometimes depends on the quality of the lender’s witness who explains how the prepayment was calculated. *Compare In r Holdings, Inc.,* 332 B.R. 380, 386-87 (W.D. Mo. 2006) (court relies extensively on lender’s expert witness and holds that yield maintenance clause is enforcea *aff’d*, 2006 WL 3203751 (8th Cir., Nov. 7, 2006) *with UPS Capital Business Credit v. Gencarelli*, 2006 WL 3198944 (D.R.I., Nov. 3, 2006), *rev’d on other gr* 2007 WL 2446883 (1st Cir., Aug. 30, 2007) (district court finds that lender’s witness was “clueless” and that lender is not entitled to prepayment fee).

[16] *See Atlantic Ltd. Partnership v. John Hancock Mutual Life Ins. Co.,* 95 F. Supp. 2d 678, 683 (E.D. Mich. 2000) (court lists changes to prepayment calculatio that borrower should have asked for).

2007 Telecommunications Checklist

As a service to real estate professionals and their counsel, since 1998, I have periodically assembled a checklist of action items that such professionals should consider in response to legal and technological developments in the communications area impacting real estate. This paper should not be considered legal advice, nor does it create an attorney-client relationship. Still, what follows is my best thinking on issues and developments of note. In this paper, unless specifically noted, the words tenants and residents are interchangeable. Should you disagree with any conclusion or suggestion, or would simply like to add to the discussion, email glederer@millervaneaton.com. All such comments will be incorporated into future checklists which may be found at *REsources* (http://www.millervaneaton.com/REsources/index.html) There are also a number of free downloadable forms and model communications available on the site

1. CONDUCT A 2007 TENANT NEEDS SURVEY.

Real estate professionals can never know too much about tenants' needs, especially their communications and IT needs. The only way to avoid being surprised by a tenant's technology needs is to ask what they need beforehand. As IP enabled services (VoIP, IPTV) and wireless delivery mechanisms (WiFi, WiMax, etc.) gain market acceptance, property professionals need to know their tenants' technology needs now more than ever.

You also need to understand the basics of these services. For instance, while you can dial 911 on all VoIP devices, not all devices have an E-911 feature. E-911 provides the geographical locating information a traditional phone relays to the local emergency operator. VoIP phones will also not typically operate when the electricity is down. You might suggest tenants retain a single traditional landline or cell phone, if for no other reason than to call 911 in the event of an emergency or loss of power.

Additional Insights:

*(*Visit *REsources* for a tenant survey.)

2. CONDUCT A PHYSICAL AND LEGAL AUDIT OF YOUR TELECOMM SPACE.

A physical and legal audit tells you what telecommunications space you have available in your easements, risers and on your rooftops. It will also tell you who, if anyone, has a preexisting right to those spaces, including providers pursuant to state access laws. Such an audit is especially important if you have any bankrupt providers that have equipment on your property. You should also determine what space you have available to accommodate the wires and equipment of a Telecommunication Service Provider ("TSP") that might like to serve your building/community. The need to be in compliance with the "abandoned" wires rules also supports the need for annual physical audits.

Additional Insights:

*(*Visit *REsources for a model survey.)*

3. LEARN ABOUT IP ENABLED SERVICES (IPES).

The digitization of voice, video and data transmissions by means of "Internet Protocol" and improvements in technology that permit all three services to be provided over a single wire are changing the face of the communications world. Internet Protocol Enabled

Services ("IPES") are provided over a high speed connection, typically provided by your local cable or phone company. In some new developments, these services are being offered by private fiber providers that assemble service providers to ride on the host network.

The biggest benefit of IPES to real estate professionals is that they provide the ability to offer choice without the need to run another wire into your building or through your community.

VoIP, or "voice over internet protocol," is poised to challenge, if not supplant, the local and long distance phone industry. IPTV will increasingly be available from the new AT&T to compete with traditional cable companies in the offering of video entertainment, while Verizon will compete by means of its new fiber to the home (FTTH) deployments.

There are downsides to IPES. Power and emergency identification are just two that we mentioned above. Real estate professionals need to understand the impact the migration from traditional voice to VoIP, or from cable to IPTV, will have on your bottom line or the bottom line of any communications marketing partners you may have. It is not unrealistic to believe that bundled services such as VoIP and IPTV will render separate offering of these services obsolete before 2010.

Finally, real estate professionals should investigate how IPES services might be incorporated into your business operations. (*The FCC has a whole web dedicated to the issue -- http://www.fcc.gov/voip//.*

4. UNDERSTAND THE RULES ON "ABANDONED" WIRES. MAKE SURE YOUR TENANTS AND VENDORS COMPLY.

The wires which tenants have left in your raised floors, walls and ceilings, as well as the unused cabling residing in your risers, are no longer merely a nuisance. They may now render your building out of code and jeopardize your fire insurance. Changes in the 2002 and 2005 editions of the National Electric Code ("NEC") make it a violation either to have abandoned wires in your building's risers/plenums or to use any wires not specified by the NEC. For a detailed paper on what constitutes an abandoned wire and what are some of the pro-active steps you can take, read Changes in National Electric Code Affect Leases and Agreements on my web page.

5. AMEND YOUR LEASES & LICENSES TO ADDRESS ABANDONED WIRES IN THE TENANT'S SUITE.

Once you have identified and addressed existing abandoned wires, implement policies that prevent the abandonment of wires in the future. You may choose to employ security deposits or other means to address such concerns. At a minimum, you should amend your lease forms to require the removal of wires or payment of a fee sufficient to cover the removal of such wires. For more details and suggested language for leases, read Changes in National Electric Code Affect Leases and Agreements which may be downloaded from my web page.

6. KNOW THE DIFFERENCES IN RULES GOVERNING INSIDE CABLE WIRES VERSUS INSIDE TELEPHONE WIRES.

The FCC's rules governing telephone wires (47 C.F. R. § 68.105) and cable wires (47 C.F.R. § 76.804), and the right of building owners to take possession of either, are very different.[1] Cable operators retain greater autonomy over their cable wires than a telecommunication provider retains over its telephone wires. For instance, under the inside telephone wire rules cited above, a building owner has the right to move the demarcation point to the minimum point of entry and may rely upon state law to establish the price at which it may acquire inside telephone wires. Under the rules governing cable wires, a building owner may take steps regarding cable wires only if the owner has reserved that right at the time (s)he entered into the access agreement with the cable operator.

The FCC and the Courts have been very aggressive in reading cable agreements and the cable wire rules to promote access to cable wiring as a means to promote competition in cable. In *CSC Holdings, Inc. v. Westchester Terrace at Crisfield Condominium,* 235 F. Supp. 2d 243 (S.D.N.Y. 2002), the Southern District of New York ruled that the FCC rules apply only when an incumbent provider is about to be ejected from a building. Thus, the rules do not apply as long as the cable operator had a right to serve even one tenant in the building in question. A month later, in *Time Warner Entertainment Co., L.P. v. Atriums Partners, L.P.,* 232 F. Supp. 2d 1257 (D. Kan. 2002), aff'd 381 F.3d 1039 (10th Cir. 2004), the court disagreed with the *CSC Holdings* court's conclusion. The *Atriums Partners* court found that the *CSC Holdings* court had failed to recognize the distinction between 47 C.F.R. § 76.804(a), building-by-building disposition of inside wiring, and 47 C.F.R. § 76.804(b), unit-by-unit disposition of inside wiring. It held that Section 76.804(b) presumes that the incumbent cable provider may continue to provide service on a unit-by-unit basis while competitive providers serve other units. Thus, when a subscriber terminates service, the cable operator can be required to abandon, remove, or sell the home run wiring that serves that particular unit at the request of a homeowners' association (or presumably the building owner) even though the cable operator may have legal authority to continue to serve other units. Furthermore, the *Atriums Partners* court held that the Kansas mandatory access statute did not provide a basis for Time Warner to refuse to abandon, remove, or sell the requested home run wiring. *See also CoxCom, Inc. v. Picesne Real Estate Group*, No. Civ. A. PB 02-1537, 2003 WL 22048781 (R. I. Super. Ct. August 21, 2003).

The FCC in 2003 issued an order modifying its existing rules in two ways that may benefit property owners. The Commission found:

- In the event of the sale of "home run wiring" in a Multi Dwelling Unit

[1] *See In re Telecomms. Servs. Inside Wiring; In re Implementation of the Cable Television Consumer Prot. And Competition Act of 1992,* Report and Order and Second Further Notice of Proposed Rulemaking , 13 FCC Red. 3659, 3680-3693, ¶¶ 39-67 (1997), modified in part and affirmed in part, First Order on Reconsideration and Second Report and Order, 18 FCC Red. 1342 (2003).

("MDU"), the wiring must be made available to the MDU owner (or a *new* provider selected by the owner) during the 24-hour period before actual service termination by the incumbent. Id. ¶ 3. (Home run wiring is the wire that runs from a subscriber's unit in an MDU to the building's minimum point of entry. 47 C.F.R. § 76.800(d)).

7. UNDERSTAND SHEETROCK & ACCESSIBILITY.

One of the biggest issues facing developers and managers that seek to introduce a competitive provider into their developments is at what point may they access the existing wiring. The FCC has ruled that you access the wiring at a point it is accessible. The Commission further determined that home run wiring located behind sheet rock is physically inaccessible for purposes of determining the demarcation point between home wiring and home run wiring. This conclusion was successfully challenged by the cable industry.

The conclusion was not so much rejected by the D.C. Circuit Court of Appeals in *Nat'l Cable & Telecoms. Ass'n v. FCC, 8*9 F. App't 743 (D.C. Cir 2004)), as much as the court told the FCC that it failed to build a sufficient record to arrive at the conclusion.

In *Telecommunications Services Inside Wiring – Customer Premises Equipment*, CS Docket No. 95-184, FCC 07-111 (rel. June 8. 2007), the FCC reinstated the FCC's original determination. The effect of the order is to subject wiring behind sheetrock to the same FCC regulations as wiring inside individual single family residences and apartment units. Technically, the ruling allows apartment residents to acquire wiring outside their units, and the FCC seems to think this will help them promote competitive choice. In reality, use by residents is highly unlikely (and would be legally troublesome). The more practical benefit is that apartment building owners and community associations will now be able to obtain access to the same wiring without going through the cumbersome procedures in the FCC's cable home run wiring rule.

The order does not in any way suggest that the FCC has mandated access to buildings.

Visit *REsources* for an examination of various courts' opinions on the application of the "Home Run" wire rules. They have been generally supportive of promoting competitive choice.

8. DO NOT GRANT ACCESS "EASEMENTS" TO TELCO OR CABLE PROVIDERS.

Real estate counsel could best serve their clients in these days of integrated service providers seeking access to their buildings and developments by ensuring that clients understand the differences among a lease, a license, and an easement. Although the author prefers to employ a license, others have made persuasive arguments for a lease.

TSPs, including cable multi-service operators, competitive local exchange carriers, and some Bell companies, are submitting easements rather than licenses for access to buildings. Easements are less desirable for owners than licenses for several reasons. Unlike an access license agreement, which conveys limited business rights to the telecommunications service provider, an easement confers a property right upon the carrier. Armed with such a property right, a TSP will be difficult, if not impossible, to control. Courts have issued conflicting opinions as to whether a cable operator has a right of access, under section 621(a)(2) of the Communications Act, to easements.

Several courts considering the issue have held that the Cable Act grants cable companies a federal right to use both public and private easements. *Cable TV Fund 14-A, Ltd. v. Prop. Owners Ass'n Chesapeake Ranch Estates, Inc.,* 706 F. Supp. 422, 433-34 (D. Md. 1989); *Mumaugh v. Diamond Lake Area Cable TV Co.,* 456 N.W.2d 425, 428 (Mich. Ct. App. 1990).

However, in 1992, the Eleventh Circuit held that section 621(a)(2) authorizes a franchised cable company's access to easements on private property only when the owner of the property has dedicated the easements for the general use of any utilities. *Cable Holdings of GA., Inc. v. McNeil Real Estate Fund VI, Ltd.*, 953 F.2d 600, 610 (11th Cir. 1992). The district Court had ruled that section 621(a)(2) grants cable operators the right to access any easements, even those granted by the property owner to a particular entity. The Eleventh Circuit ruled that such an interpretation would make section 621 unconstitutional, as it would require a property owner to grant access without providing just compensation. The court applied a different interpretation of section 621(a)(2) as permitting a franchised cable operator to access private easements only when the owner has dedicated the easement to general utility use. *Id.* at 610. *See* also *Media Gen. Cable, Inc. v. Sequoyah Condominium Council of Co-Owners*, 991 F.2d 1169 (4th Cir. 1993).

The *Cable Holdings* case also stands for the proposition that granting an easement in favor of the ILEC may render space in the client's building accessible utility space. See *Cable Holdings* at 608-609. The 9th Circuit has taken a different interpretation that section 621 of the Cable Act does not grant a provider the right to co-use private easements. *Cable Arizona Corp. v. Coxcom, Inc.,* 261 F.3d 871 (9th Cir. 2001).

9. LEARN THE FCC'S "OTARD" RULES AND THAT THEY APPLY TO MORE THAN JUST SATELLITE VIDEO SERVICES.

The secret of wireless communications is that they are anything but wireless. The installation of the telecomm and power wires required to support wireless devices are a real challenge to real estate professionals that will only become more acute in the future.

The challenges will come in the form of legal and physical limitations. The law is developing before our very eyes at the FCC and in state courts on these issues. Unlike its treatment of inside cable wires, the FCC has not been friendly to property owners in this area.

Since May 25, 2001, the FCC has limited governmental and non-governmental restrictions on a consumer's ability to install an antenna for transmitting or receiving fixed wireless signals, or receiving multi-channel video programming signals. The FCC's rules, cited as 47 C.F.R. § 1.4000, have come to be known as the Over the Air Reception Devices rules or "OTARD" rules.

In order to garner the FCC's protection, an OTARD must be:

1. Not more than one meter (39.37") in diameter;

2. Installed in an area for which the consumer has a property interest (a valid lease suffices); and
3. Installed in a site under the exclusive control of the consumer, i.e., it can not be a common area such as the roof or exterior wall of a multiple dwelling unit or office building.

The FCC and the Courts have reviewed matters involving the OTARD rules no less than ten times. Visit *REsources* for a collection of the decisions. Courts have tended to find for the real estate interest while the FCC has tended to find for the OTARD user.

The FCC does provide two safe harbors for banning or limiting the deployment of an otherwise legal OTARD device: safety and historic preservation purposes. From the OTARD matters that have been litigated at the FCC, these safe harbors are ports that have not easily been reached. *See, e.g.*, *In re Victor Frankfurt*, 16 FCC Red. 2875 (2001).

Most recently, the FCC extended OTARD protections to Part 15 devices such as WiFi or WiMax devices in its *MassPort* decision (ET Docket No. 05-247, released 11/1/2006).

10. DEALING WITH DEAD ZONES: IN-BUILDING WIRELESS STILL NOT WORTH REAL ESTATE'S INVESTMENT, BUT IN-BUILDING BOOSTERS FOR FIRST RESPONDERS MAY MAKE SENSE AND MAY BE REQUIRED BY LAW.

The radio signals that make cell phones, PDAs and public safety radios work are greatly reduced when passing through organic barriers (such as a tunnel or a mountain) and inorganic dense construction materials (think building walls). The result of this reduction in signal strength is that parts of your buildings are dead zones to wireless communications.

One fix for these dead zones is an "in-building" wireless or "signal booster" network that serves to create a mini cell tower within your building to counter any reductions in signal strength.

In the past, I have taken a controversial position that investing in such systems based upon the likelihood of financial reward was not a good investment for the real estate owner. Furthermore, should you invest in such a system, demand that it be a neutral host system that provides access to all carriers. I stand by both of those recommendations and believe history has proved my position to be correct.

The issue of in-building boosters to assist first responders is a very different question.

A major finding of the 911 Commission was that the first responders in the Twin Towers could not hear one another because of the lack of signal coverage in the high rises. The Twin Towers are not alone in lacking signal coverage. This will be increasingly become an issue for real estate professionals at the local level.

Some local governments, following the lead of the 911 Commission, are adopting in-building signal strength standards (see chart at the link below for examples). The challenge to the real estate industry will be to ensure that the ordinances or code changes enhance public safety communications networks and not vendors' bottom lines. As one vendor's web page taunts, "[P]rivate building owners naturally resist, so local codes and ordinances have become the vehicle to...: mandate deployments of signal

boosters."
www.RFSolutions.com/fcc.htm.

This same vendor estimates that "the relative costs of implementing a signal boosters system for building is between $0.15 and $0.30 per square foot," or, in their words, "less than the cost of trash pick up."

Unlike most building codes, the "in-building booster" ordinances or building specifications that are being adopted today mandate the requirement on all eligible buildings, not just new construction or major renovations. The code of the City of Burbank, Ca. is cited as the very first signal booster requirement. It provides:

> …[N]o person shall maintain, own, erect, or construct, any building or structure or any part thereof, or cause the same to be done which fails to support adequate radio coverage for City emergency service workers, including but not limited to firefighters and police officers.

No definitive list of communities that have adopted such ordinances exists to my knowledge, but I have seen a list of no less that 40 communities and the list appears to be growing.

11. KNOW WHERE MANDATORY ACCESS RULES STAND IN YOUR STATE AND THE IMPACT FRANCHISE RELIEF FOR TELCOS MIGHT PLAY.

Despite the bankruptcies of leading proponents of mandatory access, the issue has not gone away. There are efforts ongoing in the Congress, at the FCC and in state legislatures to mandate access to buildings.

As of today, only Texas, Rhode Island and Indiana have imposed mandatory access in favor of *telephone* companies to office buildings and MDUs. There are, however, 18 states and the District of Columbia[2] where some form of "mandatory access" rules are in place in favor of the local *franchised cable* operator.

It remains unknown whether the mandatory access rights currently enjoyed by franchised cable operators will be extended to telephone companies if Congress or an individual state adopts Telco franchise-free legislation. In part, that answer will depend on whether the state statute requires the entity be franchised by the local government as is the case in Pennsylvania.[3]

There is also the practical question of whether the entity, be it a cable or phone company, is limited in a mandatory access case to provide only cable service. For instance, if a telephone company is granted access to provide cable in a building over the

[2]The jurisdictions and the cite to their laws are: Connecticut (Conn. Gen. Stat. § 16-333a)(1975), Delaware (26 Del. C. § 613)(1983) (only if utility easements also exist), District of Columbia (D.C. Code § 43-1844.1)(1981), Florida (Fla. Stat. § 718.1232)(1982)(condos only), Illinois (55 ILCS 5/5-1096)(1993), Iowa (Iowa Code § 477/1) (1977), Kansas (K.S.A. § 58-2553)(1983), Maine (14 M.R.S.A. §6041)(1987), Massachusetts (Mass. Ann. Laws ch. 166A, § 22)(1995), Minnesota (Minn. Stat. § 238.23)(1983), Nevada (Nev. Rev. Stat. Ann. § 711.255)(1987), New Jersey (N.J. Stat. § 48:5A-49)(1982), New York (NY Pub Ser § 228)(1995), Ohio (ORC Ann 4931.04) (1998); Pennsylvania (68 P.S. § 250.503-B)(1993), Rhode Island (R. I. Gen. Laws, § 39-19-10)(1993), Virginia (Va. Code Ann. § 55.248, 13:2)(1997), West Virginia (W. Va. Code § 5-18A-1)(1995), and Wisconsin (Wis. Stat. § 66.0421)(2001).

[3] See PA Stat. 68 §250.501-B(5), which defines "operator" as "the operator of a CATV system holding a franchise granted by the municipality or municipalities in which multiple dwelling premises to be served [are] located."

owner's objection, can the owner legally prevent the telephone company from offering phone service? A second legal question is whether the property owner has breached an exclusive contract with an existing provider if the owner provides providing access to the telephone company as required by law.

Visit *REsources* for updates on where things might stand in your state.

12 STAY ABREAST OF DEVELOPMENTS IMPACTING YOUR ABILITY TO EXECUTE EXCLUSIVE CONTRACTS

Despite having banned exclusive contracts between office building owners and common carriers,[4] the FCC has not extended the prohibition to residential properties. (Editors note: The FCC is poised to address the issue at an opening meeting on October 31, 2007.) The Commission has on more than one occasion declared that exclusive agreements in the residential setting can be pro-competitive.[5] However, the Commission is currently examining where and when a real estate owner might enter into exclusive contracts. Speculation is that exclusives contracts could be banned in an October, 2007 order (See dockets 99-217, 96-98, 95-184 & 92-260).[6]

13. UNDERSTAND COLR AND COMPENSATION RULES.

Prior to the Telecommunications Act of 1996, carriers of last resort often enjoyed exclusive local franchises, such that building owners and developers faced with the practical necessity of providing telecom services to their tenants had no option but to grant access to the incumbent carrier. In some states, building owners operated under the threat, if not the actual exercise, of eminent domain powers by existing telecommunications carriers to obtain access. Therefore, while a tradition, it is incorrect to treat existing carriers as invited guests. In fact, using Carrier of Last Resort ("COLR") as a means to open a building owner's property to the carriers would compound potential Fifth Amendment issues.

A new issue is being debated in Florida where the COLR is stating that not only are they entitled to access developments, but are entitled to provide any service, regulated or unregulated, to the property. Should a property owner have the temerity to tell the COLR that it is limited to provide regulated services, the COLR is threatening not to provide services.

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[4] *See* FCC Order No. 00-366, In the matter of Promotion of Competitive Networks, First Report and Order, WT Docket No. 99-217 (rel. Oct. 25, 2000). The rule reads:

> No common carrier shall enter into any contract, written or oral, that would in any way restrict the right of any commercial multiunit premises owner, or any agent or representative thereof, to permit any other common carrier to access and serve commercial tenants on that premises. 47 C.F.R. § 64.2500.

[5] *See, e.g.,* FCC Order No. 97-376, In the Matter of Telecommunications Inside Wiring, Report and Order et. al, CS Docket No. 96-184, MM Docket No 92-260, rel. October 17, 1997.

[6] As recently as February 1, 2007, FCC Chairman Martin stated: "We will continue to take steps to remove regulatory impediments to the entry of new service providers into the video market by, for instance, ***ensuring that consumers living in apartment buildings are not denied a choice of cable operators"*** (Emphasis added). Testimony Prepared for Full Senate Commerce Committee Hearing on Accessing the Communications Marketplace: A View From the FCC delivered by Chairman Martin is available at www.fcc.gov.

On March 13, 2007 the Florida Public Service Commission rejected these arguments in two important petitions.

1. *BellSouth Petition for COLR Relief (Nocatee Development)* – Limiting COLR to voice service in a development where competitor has been granted exclusive video and data rights does not rise to level of good cause for COLR relief, but may require developers/homeowners to make contributions in aid of construction.
2. *Embarq Petition for COLR Relief (Treviso Bay)* – Limiting COLR to voice service in a development where competitor has been granted exclusive video and data rights, and homeowners dues are used to pay for those services, does not rise to the level of a good cause waiver.

13. MAKE SURE CLIENTS UNDERSTAND BANKRUPTCY LAW AND THE LIMITATIONS ON SELF HELP.

TSPs once flooded with cash are now cash-poor or broke. Real estate counsel must assist property professionals to protect their constituents in the event of a TSP business failure: the building owner, the tenants, and the property professionals themselves. The plan of attack must ensure that:

- The building owner is protected from potential losses in revenue as well as from liens placed against the building by the subcontractors of the TSP;
- The tenants are protected from the loss of telecommunications services; and
- The property professionals are protected from themselves as they seek to engage in self-help.

Some suggestions on how such a plan may address these needs:

- Draft access agreements that require a letter of credit and also establish a priority position for abandoned property. Language might require in the event of the abandonment of telecommunications service facilities, the building owner may order the TSP to promptly remove the facilities from the building and restore the building to its prior condition or may declare the ownership of such facilities to have been abandoned and forfeited to the building.
- Police the title of the building to see if the TSP's subcontractors have registered mechanic's liens against the building.
- A TSP will likely continue to pay its rent. But if a TSP fails to make payment either before or after filing for bankruptcy, depending on the exact language used in the letter of credit, the building owner may be able to recover any unpaid license fees and other debts from the letter of credit.

About the Firm: Miller & Van Eaton, P.L.L.C. offers specialized services in communications law. Real estate clients rely upon Miller & Van Eaton for counsel and legal representation on a wide range of business and regulatory matters that relate to every communications industry.

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Subprime Mortgage Market Developments

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The subprime sector of the mortgage lending industry has recently been going through turbulent times, which have led to the ongoing crisis affecting not only this industry, but also the housing market, other related industries and global financial markets.

The subprime mortgage meltdown began in 2006 with a steady increase in foreclosures, a decrease in home prices and sales, rising interest rates and subsequent bankruptcies or closedowns of subprime lenders. This meltdown reached its peak in the summer of 2007 when some subprime lenders had a sharp decrease in liquidity which threatened their ability to meet loan origination obligations, and when prices of securities backed by subprime mortgages dropped drastically.

On August 17, 2007, the Federal Reserve opened the discount window to allow subprime lenders to borrow money at the discount rate to meet the temporary shortages of liquidity. This action was followed by a half point cut of the interest rate by the Federal Reserve and other measures designed to inject liquidity into the banking system. The discount window and the interest rate cuts are only short-term solutions to the problem and will not solve all of the problems plaguing the subprime mortgage lending market.

President Bush attempted to address some long-term solutions to the problems associated with the subprime market in his speech of August 31, 2007. He encouraged lenders to work with borrowers to adjust their mortgages when needed and promised to provide government intervention aimed at assisting subprime borrowers to avoid defaults on their mortgages. This government initiative would: 1) allow certain borrowers to participate in Federal Housing Administration programs; 2) launch a foreclosure avoidance initiative; 3) increase financial literacy of the subprime borrowers; 4) provide tax relief to certain borrowers; and 5) require lenders and brokers to provide improved and clearer disclosures to borrowers.

Whether long or short-term, substantive corrections to the current situation in the subprime mortgage lending market are necessary. In order to find the right solutions to the problems troubling the industry, it is important to look to the core of the crisis, which relates back to the original subprime borrowers and defaults on their mortgages.

<u>Background</u>

Generally, subprime borrowers are borrowers that display some credit risk characteristics, which typically include weakened credit history or low repayment capacity. Subprime loans have a higher risk of default and potentially higher gains than loans to prime borrowers.[1]

To meet the credit needs of subprime borrowers, lenders have developed various innovative products. Some of these products have low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable rate plus a margin for the remaining term of the loan (Adjustable-Rate Mortgages, or ARMs). Some ARMs often include prepayment penalties, no or very high payment caps or periodic interest rate caps, "balloon" payments, loan features that result in frequent refinancing, or require borrowers to pay insurance and taxes separately from their mortgage payments. These products could potentially result in "payment shock" to the borrower, and consequently cause the borrower to default on the loan.

Subprime lending should not be confused with predatory lending.[2] Subprime lending is not predatory per se. In fact, when a subprime loan is appropriately underwritten, priced and administered, it provides a great vehicle for subprime borrowers to obtain credit. However, there are forms of subprime lending that can be considered predatory and abusive.

Problem Areas

The main problem areas in the subprime mortgage lending market are associated with the sharply increasing number of defaults (loans that are 90 days or more past due) and foreclosures. Defaults and foreclosures are caused by a variety of factors or any combination thereof.[3] In addition to risky underwriting standards, predatory lending practices, or payment shock features described above, defaults may be caused by the financial inability of a subprime borrower to make mortgage payments, which is frequently caused by job loss, significant medical expenses, divorce or other financial challenges.

Proposed Solutions

Although borrowers, lenders, investors and regulators seem to clearly recognize the primary problem areas in the subprime mortgage lending industry, there appears to be no consensus in finding a corrective solution to these problems.

The solution involves several possible approaches which are being discussed by various groups. Some propose that federal legislation prohibiting certain practices can be enacted, while others suggest that regulatory agencies' or states' guidelines or regulations would

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[1] The terms "subprime," "subprime loans," and "subprime borrowers" are defined in the *Expanded Guidance for Subprime Lending Programs*, issued on January 31, 2001.
[2] Predatory lending practices are more specifically discussed in the *Expanded Guidance for Subprime Lending Programs*, issued on January 31, 2001.
[3] Various factors causing foreclosures, with an emphasis on the role of predatory lending practices in foreclosures of subprime mortgages, are explored in detail in the Office of the Comptroller of the Currency's Economics Working Paper: 2006-1, *Forclosures of Subprime Mortgages in Chicago: Analysing the Role of Predatory Lending Practices*, August 2006, which can be found at http://www.occ.treas.gov/ftp/workpaper/wp2006-1.pdf

be more beneficial, as they would give more flexibility and discretion to lenders. Questions also arise as to whether these new laws or regulations should aim either at improving financial literacy of borrowers or at limiting certain lending practices, requiring additional disclosures and tightening underwriting standards, or both. There is a wide variety of opinions as to whether lenders should underwrite "low-documentation" or "stated income loans," and whether lenders should have the burden of determining a borrower's ability to repay, thus placing more liability on lenders rather than on borrowers.

The subprime mortgage lending market is already subject to a number of federal and state laws, including the Real Estate Settlement Procedures Act,[4] Truth in Lending Act,[5] and Home Ownership and Equity Protection Act,[6] that provide consumer protection to borrowers. However, some concerns about consumer protection still remain unresolved. A number of states have either enacted or proposed legislation that focuses on subprime lending issues or predatory lending practices. Unfortunately, there is no uniformity among the states, which creates a great deal of compliance problems for national lenders. There is a slew of bills proposed on the federal level as well.[7] It remains unclear, however, whether the proposed federal legislation will ultimately help the borrower or whether it will restrict the availability of credit in the subprime market. Obviously, enactment of any new federal laws would also create concerns of federal preemption of conflicting state legislation.

The abundance of state and federal enforcement actions, as well as plaintiffs' cases, against lenders will provide additional corrections to subprime mortgage lending practices.

On the regulatory level, federal financial regulators[8] have issued several statements regarding nontraditional mortgage products,[9] stratagies for working with borrowers,[10] and

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[4] 12 U.S.C. §1261 et seq.

[5] 15 U.S.C. §1601 et seq.

[6] 15 U.S.C. §1639.

[7] Some pertinent bills are: Obama, *S. 1222* (April 25, 2007) (To stop mortgage transactions which operate to promote fraud, risk, abuse, and under-development, and for other purposes). Schumer, *S. 1299* (May 3, 2007) (To establish on behalf of consumers a fiduciary duty and other standards of care for mortgage brokers and originators, and to establish standards to assess a consumer's ability to repay, and for other purposes). Bachus, *H.R. 3012, Fair Mortgage Practices Act of 2007* (July 12, 2007) (To amend the Truth in Lending Act to provide for the establishment of fair mortgage practices, generally, and for subprime mortgages in particular, to provide for a national system for licensing or registering residential mortgage loan originators, and for other purposes). Ellison, *H.R. 3081, Fairness for Homeowners Act of 2007* (July 18, 2007) (To amend the Truth in Lending Act to protect consumers from certain practices in connection with the origination of consumer credit transactions secured by the consumer's principal dwelling, and for other purposes). Miller, *H.R.3915, The Mortgage Reform and Anti-Predatory Lending Act of 2007* (October 22, 2007) (To amend the Truth in Lending Act to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, to provide certain minimum standards for consumer mortgage loans, and for other purposes).

[8] Federal financial regulators consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

[9] *Nontraditional Mortgage Product Guidance*, 71 FR 58609 (October 4, 2006).

subprime mortgage lending. The Statement on Subprime Mortgage Lending[11] concentrates on underwriting, risk management, internal controls and consumer protection regarding hybrid ARMs, no or low-documentation and other subprime mortgage products. The Statement on Subprime Mortgage Lending is supervisory in nature and, although it applies only to federally regulated institutions, including banks, thrifts and credit unions, it impacts other lenders as well.

To address similar issues related to securitized subprime mortgages, federal financial regulators and CSBS issued a Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages.[12] This Statement encourages federally regulated financial institutions and state-supervised entities that service securitized mortgages to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve home ownership, if authorized by pooling and servicing agreements.

<u>Conclusion</u>

The heightened default and foreclosure rates will most likely continue for some time. However, the demand for subprime mortgage products is not expected to decrease. Certainly, the market will correct itself over a period of time. In the interim, we will likely see the emergence of a great deal of legislation, regulations or guidance addressing subprime mortgage lending issues in the near future, which will, hopefully, help to stabilize the present crisis in the subprime mortgage lending market.

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[10] *Statement on Working with Mortgage Borrowers*, issued on April 17, 2007, which can be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070417a1.pdf

[11] *Statement on Subprime Mortgage Lending,* 72 FR 37569 (July 10, 2007). Following the issuance of the Statement, the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators and the National Association of Consumer Credit Administrators adopted a similar document, *Statement on Subprime Mortgage Lending*, for state banking regulators to issue to their licensed mortgage providers.
http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf

[12] *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*, issued on September 4, 2007, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf