Real Estate Transactions Outline– Fall 2004 - Saulsich

Arranging the Deal

- Conveyancing/Basic Concepts and Terms
- Lawyers
  - Rule 1.7 = Conflict of Interest
    - The requirement of informed consent and the requirement of explaining common representation to the multiple parties involved
  - Canon 5 = There are many instances where a lawyer can properly serve multiple clients having potentially differing interests.
  - Disciplinary Rules = 5(c) a lawyer may represent multiple clients if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect
  - In re Lanza → D = Attorney who is retained by the seller and is asked to be retained by the buyer. Attorney agrees to be retained by the buyer before discussing it with the seller.
    - Misrepresentation about leaky basement ruins deal
    - Attorney is brought before the disciplinary commission for trying to represent both parties

- Brokers
  - Unauthorized practice of law → mostly arises from the action of brokers
    - Authorized practice of law by people who are not licensed = what brokers do. More accurate to say this than to say that what the broker does is not really the practice of law.
    - Tests =
      - Incidental Test = non-lawyer may perform some legal tasks if they are minor and only incidental to the main service being offered.
      - Simple-complex Test = non-lawyers may perform simple legal tasks; only lawyers may perform complex ones.
      - Personal Representation Test = while a non-lawyer may not give legal advice to others, he may perform legal services or himself.
  - 4 types of listing arrangements:
    - Exclusive right to sell = gives the broker right to a commission if the property is sold by anyone, even the owner, during the term of the listing agreement
      - Service broker is going to provide – reasonable effort and due diligence
        - Promises:
Broker promises to use reasonable effort and due diligence to find a buyer
Seller promises to grant broker the exclusive right to sell
Seller promises to pay broker if property sells within this period

**Exclusive agency** = gives the broker right to a commission if the property is sold by anyone, except the owner, during the term of the listing agreement.
* Must produce buyer who is **ready, willing and able to perform**

**Open** = broker gets commission only if the broker is the first to procure a buyer

**Net**

**Designated Agency** = firm represents both seller and buyer and who represents who is designated ahead of time

**Transaction broker = 339.720**

**Agency** = normal relationship between broker and seller

- **Seller liability to Broker**
  - **Galbraith v. Johnston** → any work done for the buyer is actually done for the seller
    - At what point does the broker earn the commission? – producing a buyer who is ready willing and able to perform
    - If broker is the exclusive agent of the seller, if anyone to whom I spoke buys the property, broker gets commission.
  - **Tristram’s Landing, Inc. v. Wait** = When is the commission earned? → When money changes hands and the transaction closes. No sale consummation = no commission
    - What if the **buyer** signs the contract and then defaults for whatever reason, can broker go after defaulting buyer? – Note 5 (p. 47)
      - Yes, broker = third party beneficiary; hard argument to make
      - Yes, implied promise by buyer to not interfere with the broker’s chance to make money
      - **Tortious interference** with prospective economic advantage
    - Failure to close that’s neither the seller nor buyer’s fault (e.g. buyer is simply unable to get financing on contract terms, seller’s title proves unmarketable) – what happens to the commission?
      - Who is in better position to know the problem and correct problem with the title – seller or broker? → Seller, sometimes
Broker’s duty to Seller and Buyer Article 7 of Realtors Code of Ethics = In accepting employment as an agent, realtors pledge themselves to protect and promote the interests of the client. This obligation of absolute fidelity to the client’s interests is primary, but does not relieve realtors of the obligation to treat fairly all parties to the transaction.

- Creates fiduciary relationship between broker and seller when seller signs contract with broker

Daubman v. CBS Real Estate Co. ➔ No commission if broker puts her interest ahead of the client’s interest.

- What did she do to make people so upset?
  - Seller is trying to build a new house that would not be finished by the time the transaction was completed.
  - Contract said buyer had 30 days to get financing or the deal was over. Buyer didn’t get financing the first time, so broker took buyer to a new mortgage company without telling the seller.

Hoffman v. Connall ➔ Disclosure

- Seller should bear the risk of loss that the boundary line information may be inaccurate.
- Reasonably prudent buyer = have boundary lines checked via survey or look at seller’s survey; bought title insurance
- Seller = survey before putting property on market
- Innocent and Non-negligent Misrepresentation = Broker is not responsible
  - Real estate broker has no responsibility to disclose psychologically impaired real estate in MO ➔ real estate in which a murder or suicide had been committed or in which a person who had a disease lived

Contract of Sale

- Risk of Loss = can be bargained for in the K
  - Heavy use of conditions
    - Condition of premises, financing condition, etc.
    - Do these conditions represent good faith concerns or are they devices to get out of the contract later?
  - Choice of remedies
    - Specific Performance or Damages
    - Devices to make injured party whole or leverage for settlement?
  - Equitable Conversion = in a K between B and S, B is responsible for the loss that occurs after K is signed because responsibility for the property is converted to the B at the signing of the K
    - S – I promise to transfer
      - S has legal title to the property
    - B – I promise to pay
      - B has title to money
    - Uniqueness of the property is presumed
• System of property exchange is based on the land, not the improvements on the land. Therefore if anything happens to the improvements on the land, the buyer still gets what he bargains for.
• Buyer can sue for specific performance, an equitable remedy, therefore it is fair for the buyer to take the loss.
  o Buyer gets benefits at this point since B can sue for specific performance therefore it is only fair for B to bear burden of loss.
  * Bilateral K – promise is consideration
    o Sanford v. Breidenbach ➔ Buyer does not have risk of loss because Seller did not perform his part of the contract
      * Condition precedent ➔ S had to make sure that easement to the septic tank would be preserved for the B before the K was finished
      * S was trying to induce specific performance ➔ an adequate remedy at law exists right?
        • To be fair, if a remedy exists for one side, it should also exist for the other side
      * No equitable conversion because the Seller has not done its job
      * Insurance Companies – both sides had insurance on the property
        • B’s based on equitable conversion
        • S’s based on legal title
        • Only the S’s insurance has to pay because he was the one responsible for the risk of loss
        • Once B was able to walk away from K so was his insurance company
      * Fortuitous event (the fire) – would it excuse the B’s performance under any set of circumstances?
        • The building is only partially destroyed – does the B have to take the property?
          o Not with this condition precedent
        • What if the destruction increased the value? – Does the B have to take the property
          o UVPRA = Uniform Vendor and Purchasers Risk Act allocates risk based on possession
- Statute of Frauds = Real Estate K’s must be in writing and signed by the parties charged
  o Baliles v. Cities Service Co ➔ does the writing really qualify as an integrated, written K?
    * Oral Agreement to sell lots, purchaser goes to bank and bank wants to see the K
      • Writing = letter written from the Seller to Bank
      • Buyer = Seller’s employee
      • Writing does not sufficiently identify the property by county and state – does not comply with Statute of Frauds
    * Equitable Estoppel – S helped B obtain loan
• Buyer made improvements on the property = part-performance
• Possession of property was transferred
  ▪ Does Statute of Frauds serve any purpose in this context?
    • Court must know that the contract actually existed for the unique object
    • Deed, Loan Agreement and Listing Agreement are usually involved – is a written K really necessary
    • Forces people to sit down and talk through the conditions and what is received and what is given.

- Conditions
  o Information – conditions are substitutes for information usually
    ▪ Time to check out the information needed to ensure K
    ▪ Contingency clauses should prescribe the timing and type of notice that must be given in order to terminate the K under the contingency clause
  o Flexibility to back out
    ▪ E.g. = house on the market for $250K. Buyer says I will purchase the house if the real estate taxes do not exceed $3500 – probably only there to give B chance to back out
  o How does the law respond?
    ▪ Law sometimes implies a condition – implied obligation to act in good faith
      ▪ Implied condition of marketable title.
  o 2 problems:
    ▪ Conditions may be too indefinite to be enforceable.
      ▪ Both parties may cancel – neither party has an obligation to perform.
      ▪ Standard = reasonableness
    ▪ Condition may be illusory = nothing really has to be done.
      ▪ Implication = good faith must be used to carry condition out.
      ▪ Only the buyer is excused from obligation to perform
      ▪ Too specific
  o “Subject to” Financing
    ▪ Homler v. Malas → K did not state the rate at which the buyer is to obtain the mortgage loan – court says K is too vague
      ▪ Court could imply condition of “affordable rate” or “reasonable rate”
      ▪ Very subjective condition, unless “current market rate” is an acceptable implication
      ▪ Buyer has to accept loan from Seller if Seller offers the rate specified by the K → Kovarik v. Vesely
    ▪ Court will imply good faith obligation to diligently seek financing on the terms specified – going to one place is not enough
  o Marketable Title = title that is free from reasonable doubt – not necessarily perfect title
Caselli v. Messina → K stated that the property was sold subject to “covenants, restrictions, reservations… of record… provided same are not violated by present structure or present use of premises or render title unmarketable.”
  - Free from reasonable doubt → does not mean use of land in this case b/c there was a covenant on the property restricting use, but the court concluded that the covenant didn’t make the title unmarketable
    - Means essentially **free from defects in the chain of title not free from encumbrances** that are not visible
      - Chain of title = O → A → B → C → D
      - A defect here would be that B never really owned the property.
    - Encumbrances = split in authority on who should accept the risk for certain visible encumbrances like road widening easements
  - **Adverse Possession** → ok for marketable title
  - **Record Title** = title that can be proved by reference to the record alone and without resort to collateral proceedings such as quiet title actions brought to establish seller’s title by adverse possession
    - Chain of title
    - Adverse Possession – NOT record title
  - **Insurable Title** = title that an insurance company is willing to insure as valid
  - Operating Procedure:
    - Buyer should inspect the record and the property (looking for adverse possession)
    - **Zoning** = not the same idea that there should be a warranty, **everyone is presumed to know the government’s law**
      - Dover Pool v. Brooking → **basic assumption** of the K that the property could be used for swimming pool was mistaken = no K
    - **Quantity** = selling in gross or by acre → how concerned am I about the quantity of property? We may be very concerned about the boundaries, but the quantity is probably not important
      - Cedar Lane Ranch v. Lundberg → **in gross or by acre**
        - Who is buying the property should matter → agricultural purchaser and developer purchaser should be concerned with how much acreage they get; a residential purchaser probably is more concerned with boundaries than acreage
        - Courts are reluctant to permit abatement for a deficiency in acreage if the K calls for a certain number of acres but does not specify a price per acre
          - If deficiency is large enough, an abatement may be ordered.
      - Land use Controls
        - Enacted before signing
- Enacted after signing
- Violated
- Deed description → I should be able to find it and distinguish it from every other tract of land
  - Deposit → Incentive to the Buyer to close NOT to walk away
    - 1-3% non-refundable → $1,275 - $3,850
      - **Estimate of future liquidated damages** – giving up the chance to go after it in a suit
      - Could be **characterized as a penalty** if it is non-refundable
      - Broker may have a claim on the deposit – not enough to pay broker’s commission
        - Give broker cause of action against Buyer or give seller indemnity against broker
        - Standard = find a ready, willing and able buyer
    - 10-20% → allows for the 6-7% for the broker + the incentive
    - 1-3% now and 10-20% once the financing has been obtained → all this money goes towards payment on the house
- Remedies for Breach of Sales Contract:
  - Specific performance
    - If the buyer doesn’t have the money, the buyer doesn’t have the money
    - If buyer does have the money – the seller can’t put the property back on the market because he must be able perform the contract
    - No specific performance if:
      - Seller has no title to the property or has already sold it to 3rd party.
      - K language excludes specific performance – maybe through liquidated damages provision.
      - Purchaser was only buying the property to resell it immediately – monetary damages are sufficient in this case
    - Takes a long time to get this done – disadvantage for both parties
  - Damages
    - Two different rules which are competing
      - Modern developing rule is the Kuhn case – measure of damages is the **contract price - price at resale**.
      - Majority rule which is **contract price – FMV price at date of breach**
    - How do we decide FMV in this context? What is FMV? How do we determine it?
      - Highest price obtainable at open market on the open market
      - FMV = The price that a willing seller and willing buyer would agree to
      - What might be the easiest way to determine this?
        - Sell it.
      - What is our recovery if we sell it for $38,000? $50,000- ($38,000 + $5,000) = $7,000 difference.
    - What might be some concerns that we are worried about?
• The cost of litigation might be greater than the recovery
• If we want the deficiency option available to us, is there a problem with filing a lawsuit for the $7,000 difference? Court might disagree with the price it was sold at in terms of selling below FMV.
• But if we’ve sold the property, haven’t we rescinded? Then the court will dismiss the lawsuit. We have to set this up as the sale being mitigation, by sending a letter to the buyer saying we are not rescinding, but mitigating the damages.

**Liquidated Damages** = Seller retains purchaser’s earnest money deposit
• If deposit is too big, it may be characterized as a penalty and seller does not get to retain on breach.
  o Must be reasonable
• May preclude other remedies of seller – both damages and specific performance

**Good Faith Failure of Title** = restitution only for purchaser if seller’s breach is due to a good faith failure of title (i.e. not his fault)
  o Rescission and resale for seller
  o Vendor’s lien foreclosure
    • It is the notion of equitable conversion, the buyer now has equitable title (land), and the seller has equitable title (money & legal title)
    • I have this claim against your equitable title, and I have the right to enter a court and order performance on the contract as a lien against your title
    • If we go this route, what does it mean to say we are going to foreclose on our vendor’s lien, or exercise our rights under the vendor’s lien?
      • Sell the property to get the money
      • If the seller sells on the open market then he can’t convey clear title, because the former buyer has equitable title on the land
      • If you sell through vendor’s lien, then you can put it up for sale in a public market, and then if it sells for less then the contract price, you can get damages as the seller
    • As a practical matter it is not used often, it is rather complex
    • Between specific performance and a vendor’s lien, and the buyer is prosperous the lien might be better, because the court might decide that the property is not unique, and then you are left with no remedy, whereas with a lien you can sell it on the open market

**Closing the Contract**
- McDonald v. Plumb → **heavy reliance on formalities and the paper record**
  o Paper record = evidence of transactions designed to protect the interests of bona fide purchasers without notice, but only evidence not actual ownership
    • **Notary is responsible for guarding against forgery**, but here the notary actually forged the document
  o Deed is effective to transfer title without acknowledgement, but cannot be recorded without acknowledgement
- Other purposes served:
  - **Proof of ownership** in litigation – acknowledgement allows admission of evidence without further proof of authenticity
  - **Delivery** – Wiggil v. Cheney – the notary can testify to the intent of the parties to deliver property

- Deed Elements:
  - Premise = names, words of grant, facts, etc.
    - Words of grant = “hereby grant and release”
  - Habendum = “to have and to hold” + warranty clauses ➔ fee simple transferred
    - Describes interest taken by grantee.
  - Execution clause
  - Acknowledgment by notary
  - Barrier v. Randolph ➔ this conveyance is made and accepted subject to… certain restrictions and covenants
    - **Conditions should go in at the Habendum**, but they did not in this case. Instead they followed the description but appeared before the Habendum.
    - Plaintiff said that the restrictions gave D an adverse claim on property contrary to the granting clause and habendum therefore the conditions were invalid
      - P wants fee simple without restrictions
      - D was trying to transfer something less than a fee simple (fee simple determinable or fee simple subject to condition)
    - Court rejects argument – because these are covenants, they are fine
      - These **covenants do not affect title**. They affect usage.
    - Agreeing with the Plaintiff that the conditions should be stricken means favoring the successors over the original parties. Becomes a critical question in the modern subdivision.
  - **Void v. voidable** ➔ defects in the formalities of the deed make it either void or voidable
    - **Void** = if grantee has reconveyed the land to a Bonafied Purchaser for value, a void deed will be set aside even as against the Bonafied Purchaser
      - Set aside as against the grantee
      - Forgery
      - Lack of delivery
      - Fraud in the execution – grantor does not realize the document he is signing is a deed
    - **Voidable** = if grantee has reconveyed the land to a BFP, a voidable deed will not be set aside as against the BFP
      - Set aside as against the grantee
      - Fraud in the inducement
      - Insanity
      - Lack of capacity
      - Duress
• Mistake
• Breach of fiduciary duty
  ▪ Possible problems for deed acquired through foreclosure sale:
    • Announce we’re going to cry the sale outside the west door of the courthouse at noon. It’s raining, so we go inside and cry the sale at noon. Someone stays outside, misses the sale and fails to bid. \( \rightarrow \) de minimis b/c anyone should think to look inside
    • Announce we’re going to cry the sale outside the west door of the courthouse at noon. Trustee gets confused and sits in front of east door. Only Trustee’s friends are around and one of them buys the house. \( \rightarrow \) voidable b/c it involves the mechanics of the sale
    • Completely incorrect description of the property. \( \rightarrow \) Void sale b/c it was completely wrong.
    • Inadequacy of price alone can void a sale, but depends on the jurisdiction and whether procedure was followed
      ▪ Quit claim deed just as affective as general warranty deed – quit claim makes no promise as to title of deed = I give you what I have; general warranty deed = I promise no claims ever; special warranty deed = I promise no claims while I owned it
      - Delivery
        ▪ Wiggill v. Cheney \( \rightarrow \) Deceased grantor never parted with control b/c she kept the key to the safe deposit box containing deed
          ▪ Donative Intent + Delivery
            ▪ 3 types of delivery – all about control of the thing given:
              ▪ Actual
              ▪ Constructive
              ▪ Symbolic
            ▪ Delivery of land is not about control b/c it doesn’t move – symbolic delivery is enough
      - Escrow
        ▪ Delivery requirement is eliminated when using an escrow
        ▪ Key to the process = set of instructions that contain only objectively verifiable conditions
          ▪ Not submit to subjective “to the satisfaction of X”
        ▪ In re Akivis \( \rightarrow \) instructions attempted to be objective, but attorney should have inspected the property to determine whether the house was “broom clean”
          ▪ Attorney = agent for both S and B by becoming the escrow and breached his obligation to the B by failing to inspect property
        ▪ Can be useful, but is not perfect – depends on careful drafting and careful observation of conditions by escrow agent.
      - Merger = K promises get merged into the deed
      - Lender liability
Lender = For 10 years the court accepted that the lenders were responsible b/c lender is an “active participant” in the enterprise, and because the lender knew or should have known certain facts concerning the developer and the transaction the lender has a duty to exercise reasonable care to protect the Buyer from damages caused by major structural defects – Connor v. Great Western Savings
- 3rd Party Beneficiary Relationship or 3rd Party Privity Relationship
  - Great Western was more than just a lender; it became a partner with the developer.
- Binary K v. Unitary K → If binary (i.e. K between Dev. And B and separate K between Dev. And lender), then lender cannot be responsible. If unitary K (i.e. Dev. And lender are acting in such close contact that there is really only one K between Dev. And Lender and Buyer), then lender can be liable.
- Rice v. First Federal Savings and Loan Ass’n of Lake County → Lender charged a fee for inspection of the construction. The wall cracked.
  - Construction lender inspected the property, but that did not impose an implied K to make the inspection on behalf of the homebuyer.
  - The inspection was for the lender’s own good b/c the property was collateral for the lender. The inspection was not done for the homebuyer’s benefit.
    - The fee was a discount.

Warranties
- Buyers have no duty to disclose reasons for wanting to buy the property!
- **Implied Warranty of Habitability** = “There is an implied warranty that builder-vendors had complied with the building code of the area in which the structure is located. Where, as here, a home is the subject of sale, there are implied warranties that the home was built in workman-like manner and is suitable for habitation.”
- Builder/Seller → 1st Buyer
  - Builder is going to argue merger rule – the K is merged into the deed
    - Intent to part with control – the builder grants fee simple
  - Product Liability
  - Substantial part of the value is the building, therefore **what you are bargaining for is a building that can be lived in not just a piece of land** – Deed is about quality of the land not about quality of the house.
  - In the K, could state that merger will not apply to the particular provision guaranteeing habitability
- Builder/Seller → 1st Buyer → 2nd Buyer
  - **Implied Warranty of Habitability for a used home** = Blagg v. Fred Hunt Co., Inc. → **reasonable length of time** during which there is no substantial change or alteration
    - Reasonable time… = for all intents and purposes, the home is still new
- 1st Buyer → 2nd Buyer
  - No way to insert an implied warranty of habitability
- Builder/Seller → 1st Buyer → 2nd Buyer → 3rd Buyer → 4th Buyer
• No implied warranty of habitability
  o Statutory attempts to limit warranty of habitability to 1 or 2 years
    ▪ Expected useful life of a product
    ▪ Homeowner’s Warranty Program
  o **Standard of the Warranty?** What the B wants? A perfect house?
    ▪ Pool is leaking and patio is sinking – implied warranty of habitability?
      ▪ Patio is not necessary for habitation – warranty is based on **what is necessary for habitation**
    ▪ Livability → an objective standard? A subjective standard? The local codes?
      ▪ Fix this problem by inserting an express warranty into the K

**Assuring Title**
- **Title Covenants** = usually contained in a deed
  o Brown v. Lober → Rights to subsurface coal
    ▪ 1947 – prior grantor had reserved a 2/3 interest in the mineral rights on the property
      ▪ O (reserves 2/3 mineral rights) → Bost → (1957 with no mention of mineral rights) Brown
    ▪ 1974 - Brown grants coal rights to Consolidated Coal Co. for $6000 but Co. only paid $2000
      ▪ Brown sues Bost (Lober was the executor of the Bost estate)
    ▪ Brown claims a breach of covenant of seisin (barred by 10 year statute of limitations) and breach of **covenant of quiet enjoyment** (not barred by statute of limitations b/c it is a future covenant)
      ▪ Quiet enjoyment has not been breached yet b/c no one has attempted to take the coal yet
      ▪ Mine and collect the coal and sit on it for the statutory period for adverse possession
      ▪ Probably is a breach of **covenant against incumbrances**
    ▪ Warranty deed = bandages; it will not guarantee that there will not be a problem
    ▪ Bosts should have disclosed in the deed that they had only a 1/3 interest in coal
    ▪ Browns should have checked the record – they did have the record checked by the bank for loans in 1958 and 1968
      ▪ Browns maybe could have sued the lender
      ▪ Browns could have included specific reference to mineral rights in the deed
- **Recording System** = recorder of deeds office; open to the public
  o **Common law = 1st in time is 1st in right**
    ▪ Recording acts modify the rule in certain circumstances
  o **Grantor-Grantee Index** → public land records are organized alphabetically by the Grantor
    ▪ Used to construct a chain of title
- Original Owner (1st US patent) ← 4th O ← 3rd O ← 2nd O ← Previous Owner (Grantor)← Current Owner (Grantee)
- Look for mortgages, easements, covenants, etc.
- Abstract of Title = summary of all the transactions on the property
  - Tract Index = organized by the tract of land itself
  - 3 types of recording statutes:
    - Race = 1st person to record is 1st in right
      - Relies entirely on paper record – it doesn’t matter whether previous grantee is in possession if that grantee did not record
      - Actual notice does not matter if one with notice records first
    - Notice – 50% of states use this = bonified purchasers for value without notice of any prior claim are protected
      - Constructive notice = check the land and the records; if someone has possession of the land or if someone records before you in your chain of title, you could be on constructive notice
    - Race-notice – about 50% of states use this = blend of race and notice
      - Shelter Doctrine = Challenge of another purchaser’s rights to the land in court protects the challenger’s right to convey land to a 3rd person
      - 5303 Realty Corp. v. O & Y Equity Corp. → suit involving transfer of stock, but the stock was in a corporation that was set up to hold land; breach of K seeking specific performance to convey stock
    - Lis pendens = notice to all the world that there is a suit that could encumber the title
      - Installment land K → O will give title to the property after all the installments are paid; lis pendens is filed by the grantee to let the world know that the grantee has a pending interest in the property.
      - This particular lis pendens is not recordable b/c there is no property interest but a K interest
      - How to structure a lawsuit to fit into the lis pendens? → equitable conversion
        - Remedies = specific performance based on the equitable interest in the property OR file suit to foreclose vendee’s lien based on equitable conversion
    - What is the recordable interest here?
      - Permanent damages = negative easement in Boomer v. Atlantic
      - Injunction against transferring property = negative easement
      - Where would you record it? → in D’s chain of title – complicates title search process
  - Costs associated with land record system:
    - Negatively affects the alienability of land
    - Expenses of time and money to check records
    - Nuisance of frivolous lawsuits
  - Benefits of filing a lis pendens in this case:
    - Notice to future S of the problem with the land
Specific performance is impossible unless the property is kept in the D’s hands
- Kinch v. Fluke → purchaser in installment land K gets possession, but doesn’t get deed until K amount is paid; in the interim mortgagor gives $ away for other purposes
  - Buyer was in possession which was notice that required an inquiry, so subsequent title holders who recorded
  - Protection is geared to a subsequent purchaser, but the B in this case was a subsequent purchaser, so he didn’t have to look at the records
- Sanborn v. McLean → once development plan has been completed, someone who wants to do something different with his land is on notice that he has to inquire into land use records to spot restrictions
- Anderson v. Anderson → what does the term “purchaser for value” mean?
  - Recording Acts require more than nominal consideration – must be “valuable” consideration
  - No proof of valuable consideration for the conveyance of land from daughter to grandchildren → fact that other D did not record doesn’t matter since they were in possession for so long
  - Transaction must be bargained for

- Circuitous liens → some liens require multiple recording (judgment liens, etc.)
  - A – 10; does not record twice, so C can treat the transaction as if A was not there
  - B – 5
  - C – 3
  - Total is 18 but FMV has dropped to 15 → subtract B’s interest leaving us with 10, then subtract C’s 3 and A is left with 7
  - Because A was neglectful, it should bear the cost of the neglect.

- Uniform Title Standards = declares the answer to a question or the solution for a problem involved in the process of title examination - MO participates → closure to the system
  - 2.1 = Examination is to determine whether title is marketable (not perfect) – concerned about irregularities when they can be expected to reasonably expose the parties to litigation
    - What is the level of risk for litigation?
  - 3.1 = Period of Search = 50 years back unless there might be an indication that the original title goes back farther than that in which case the examiner must investigate further than 50 years
- Sabo v. Horvath → modern Alaska Gold Rush in the early 70’s
  - O transfers property by quitclaim deed to Horvath before he has completed process of patent from US
  - O receives the patent and then transfers by quitclaim deed to Sabo
  - Did O have any interest in the land he transferred to Horvath?
  - Is there anything about the quitclaim deed that would raise questions as to his transfers?
    - Horvath got whatever O had
- O did not have the patent from the US – he was still in the process of acquiring title to the land
- You don’t have title with just a K for Sale, but you do have an equitable right that can be enforced
- O only transferred equitable interest to Horvath – Court says no!
- **Estoppel by deed** = O is estopped to deny that Horvath is the rightful owner of the property b/c of the legally binding quitclaim deed
  - Likewise, Sabo got whatever O had
    - O now has the patent from the US and consequently the legal title
    - O transferred legal title to Sabo
    - Is Sabo a **bonified purchaser for value without notice**? – Yes, he didn’t have constructive notice b/c Horvath had a wild deed = outside the chain of title and Sabo doesn’t have to look beyond the US patent
- Breen v. Morehead → ruled on the estoppel by deed claim that the guy is Sabo’s position is still the winner
  - No inquiry notice just b/c you are the first person to be granted land after the US offers a patent.

- **Title Opinion** → who’s responsible if there are mistakes
  - **Abstract of Title** = summary of every transfer, beginning with the first, and indicating all other matters of record affecting the title.
  - **Liability of 3rd Parties** – seller contracts for the title check, but buyer pays for it as one of the closing costs
    - Seigle v. Jasper → abstract did not spot easement that prevented the buyer from being able to put mobile home up. What is the basis for suit against Abstracter by B? – Tort duty or K duty?
      - K is with Seller or Lender, not Buyer – 3rd Party Beneficiary argument = the B pays, the B relies on the abstract and the abstract is being done for the benefit of the B
        - But there is no privity – whereas privity does exist between S and Lender
        - Mortgage = Lender is the owner with a fee simple defeasible that ends once the mortgage is paid off
      - Even in a tort case, there must be a connection between the parties that raises the duty
        - Standard of Care = Reasonable care or competence in obtaining or communicating information
  - Lawyer disclaimer → if an attorney examining title receives information (like a funky looking survey) that would give him or her grounds to suspect a defect, the attorney owes the client a duty of investigation that cannot be disclaimed.
  - Lawyer liability to 3rd Parties → No negligent misrepresentation b/c **lawyer is an independent contractor**
paid for by the bank – there’s a conflict of interest for the lawyer who is working for the lender and the buyer
  o Lawyer also has a duty to the public to ensure that the system operates correctly.
  o Marketable Title Acts → attempts to limit responsibility for public records
    ▪ If you don’t re-record every 40 years – you lose the claim
- **Title Insurance** = policy promising that if the state of the title is other than as represented on the face of the policy, and if the insured suffers losses as a result of the difference, the insurer will reimburse the insured for that loss and any related legal expenses, up to the face amount of the policy - lenders and commercial buyers; rare in residential real estate
  o Can have Title Insurance Co. indemnify lender’s priority position
  o Title Co will make sure that the Seller is ultimately responsible for any badness

Financing the Purchase
- **Mortgage** = “Dead Pledge” = Lender takes possession of the property not to grow crops, but for other purposes = Eventually the pledge will be cut off.
  o Lender got a fee simple subject to condition subsequent
  o Borrower/Buyer got a right of re-entry on condition broken – it’s your property so long as I owe you the money, but if I pay you, then I have a right to re-enter and take the property
  o Mortgage Terms
    ▪ **Prepayment penalty** = pay a fine for paying off the mortgage too soon
      • Watch out for **Usury Law**
      • Could be classified as an unlawful penalty
      • Restraint on alienation when Due on Sale Clause operates in conjunction with this clause
      • Related in any way to identifiable loss?
    ▪ **Due on sale clause** = full value of the mortgage is due on sale of the property by the mortgagor
      • Triggered by signed K? – equitable conversion occurs when specific performance is available (i.e. now if there are no contingencies – no guarantee yet and no signed note)
        o Not yet triggered, but sometimes it is on the signing of the K
      • On occurrence of conveyance, the due on sale clause is triggered
        o Lender in a difficult position b/c the person taking the mortgage is a credit risk
          ▪ Isn’t this taken care of by the dad’s guarantee
        o Lender is not going to get the higher interest rate – not very persuasive
      • Clause does not operate automatically – good for Lender’s argument
- **Equity**
o Note specifies specific due date by which the loan must be paid off; promise to pay
  ▪ When due date wasn’t met, Tenant would go to the Chancellor, and he would say the Note wasn’t fair so we’ll give you more time

o Equitable right to redeem to B whenever
  ▪ Foreclosure = B’s equitable right to redeem the property will be cut off if B does not pay off the loan this one last time

- **Note + Deed of Trust** = Trustee holds title to the property so foreclosure sale occurs quicker
  o Trustee = attorney, secretary, strawman → real party of interest = lender
  o Because trustee is a disinterested 3rd party, lender may bid on foreclosed property

- **Note + Mortgage** = Mortgagee has the power of sale through the foreclosure process
  o Note and Mortgage terms = Goebel:
    ▪ Note terminology controls
    ▪ Note permitted mortgagee to vary interest rate, but did not contain language permitting an increase in the interest rate or the length of the term
    ▪ Even though such language was in the mortgage, court refused to allow lender to implement proposed increase

- New Mortgages
  o **Adjustable Rate Mortgage (ARM)** – Interest
  o **Price Level Adj. Mort (PLAM)** – Principal
    ▪ Adjusting the amount of the monthly payment
    ▪ You can increase/decrease the amount that goes to principal
    ▪ You can take a long-term fixed rate mortgage at the lowest rate, and then you make a double payment, and the extra amount goes to principal – which would allow you to pay it off in half the time
  o **Renegotiable Rate Mort (RRM)** – Rollover
    ▪ Commitment for 30 yrs, possibly, but every 5 yrs. or so, we renegotiate the rate
  o **Graduated Payment Mort (GPM)** – Payment
    ▪ “yuppie” loan – people with good prospects of increasing their income over time, but might not have that much money right now
  o **Growing Equity Mort (GEM)** – Pay/Prin
    ▪ Increase the amount that goes to principle, increasing mortgage payment, or informally, making an extra payment
  o **Shared Appreciation (SAM)** – Equity Share
    ▪ Used primarily in commercial transactions
    ▪ Sometimes a lending institution would like to participate as an investor
    ▪ In addition to getting a particular mortgage payment, the lender will get a % of the profits, in exchange for a reduced rate of interest
  o **Reverse Annuity Mort (RAM)** – Equity/Annuity
Primarily for elderly people – paying more up front and then less over time
The problem with them is that people don’t understand them; families get surprised by the implications – thus, it requires a fair amount of counseling prior to entering into the arrangement

- **Secondary Mortgage Market** = attempt to help people obtain affordable housing in order to put more people to work
  - Government buys the mortgages
  - Government National Mortgage Association (Ginny Mae) + Federal National Mortgage Association (Fanny Mae)

- **Purchase Money Mortgage** = between Seller and Buyer alone; Buyer pays for the Mortgage over a period of time
  - Seller has the first priority position if there is a default
  - Done in some cases where the B cannot quite get a big enough loan – S would have to take a junior position and might do it for a higher interest rate or more $

- **Deed Absolute** (Equitable Mortgage) = B gives Lender a Note and the Deed; Lender gives separate promise to return the Deed once the mortgage has been paid off
  - Deed doesn’t get returned.
  - B has no common law remedy against L except for damages
    - B has to take it up with the Court of Equity
  - Tahoe National Bank v. Phillips = L wants a pledge that D won’t sell the property
    - L claims this is an equitable mortgage, court says no.
      - L wanted the flexibility to go after property under secured mortgage or to go after D’s home under an unsecured equitable mortgage.
    - Courts historically have been very protective of the borrowers – Mortgage law = 1st consumer protection law

- **Installment Land K** = Seller gives K and possession; B takes possession and pays over time; once the K has been paid off, B gets the Warranty Deed
  - Looks like a lease or rent situation
  - If B cannot pay full amount, S keeps all the money paid and gets to retake possession of the property
  - SEE LAND SALES CONTRACTS BELOW

- **Long term ground Lease** = control of land is more important than fee simple title
  - Can even get a mortgage = Leasehold Mortgage

- **Lender’s risk** assessment:
  - Credit risk
    - Cash flow
    - Ability to repay
    - Amount of equity – high interest + high loan to value ratio = default usually
  - Interest rate risk
- Short term v. Long term loans
  - Short term = much lower interest rate risk but much greater credit risk
  - Long term = much greater interest rate risk but lower credit risk

-Terms of the Note that can be adjusted to complete the deal/ Credit Quartet:
  - Loan to Value Ratio (Down Payment)
  - Length of Mortgage
  - Interest Rate
  - Rate of Amortization
    - Level
    - Variable
      - Increased risk with variable terms
        - Borrower = “payment shock”
        - Lender = increase in default
        - Problem of ambiguous or onerous terms (Goebel)
  - Dragnet Clauses = If you borrow additional funds when the bank already has
    your mortgage, there might be a clause attaching the additional loan to your
    mortgage, so that if you default on the additional loan, your home can be used
    to collect on the loan
    - There is a consumer protection bent to courts right now, where the
      instrument must be clearly drawn and easily understood, etc.
  - After Acquired Property Clause
    - We already have debt, and we buy a new home, can we use the new
      property to get the first home?
    - Why might this not be effective with real property? It won’t show up
      in the first mortgage’s chain of title, so a BFP for value will be
      protected
    - Personal property will be able to gone after though – more successful
      in that situation

-Affordability:
  - Monthly expenses should = 30% of income
    - Income = 40,000; Monthly expenses should not exceed 1000/month –
      (40,000 x 30% = 12000 per year/12 months)
  - Total purchase cost of the property should not exceed 2.5 x income
    - Income = 40,000; Affordable sales price = 100,000 (2.5 x 40,000)

-Underwriting Process
  - 3 hazards of secured loan:
    - Property itself = security for the life of the loan – more significant, the
      longer the loan is
      - Present value v. future value
      - Appraisal = Market Value based on comparable properties in
        the neighborhood
        - Income that could be generated from property
          - GMRM = Gross Monthly Rent Multiplier = rent
            the property could earn based on comparable
            properties
Cost to replace = cost of construction + cost of land \(\rightarrow\) not accurate for older homes that are built with different techniques and materials
- \(\$100\) per square foot; 1200 square foot house = \(\$120,000\) to build

Reconciliation = Does not average the 3 things above, but picks one and adjusts it based on other choices.

Principle of substitution applies to all 3 options for the appraiser
- Comparable properties = similar size, built around the same time, sold most recently, similar or same neighborhood, similar school districts, access to shopping/entertainment
- Housing submarket = neighborhood or something different

20 homes @ \(\$60,000\) = \(\$1,200,000\) Cost

(17,000 @ 30%) Rent \(\$500\) per month = \(6000 \times 20 = 120,000\) GI
- (MINUS) Operating Expense \(200\) per month = \(2400 \times 20 = 48,000\)
  - Net Operating Income (NOI) = 72,000 = GMRM, only if future in taken into account, reconcile this number with the cost of building the home
- Divide NOI by Capitalization Rate [estimate designed to represent return on lender’s investment + investor’s desired return] (.10) = \(\$720,000\)

Neighborhood evaluation
- Redlining = lenders once marked local maps in red pencil to indicate neighborhoods in which loans were disfavored
- Lenders have historically refused to make mortgage loans in blighted or deteriorating urban neighborhoods
- Neighborhood Obsolescence?
  - Home Mortgage Disclosure Act = Congress says publish geographic distribution of loans so that people can put pressure on the lenders if the loans are not distributed fairly across geographic boundaries
  - Refocus underwriting standards = instead of looking at a neighborhood or area, look at blocks or streets – Philadelphia Mortgage Plan
    - Encourages gentrification – where do the poor people go when all the rich people move in?
  - Obsolescence factor is not necessarily true

Borrower’s ability and willingness to repay
- Predatory Lending = charging exorbitant rates to ethnic minorities and women
- **FHA + VA** = provide insurance for lender that borrower will repay
  - Underwriting guidelines were based on 2 assumptions:
    - Racial integration has a negative affect on prices – wrong; diversity is good!
    - All neighborhoods have a obsolescence point at which they should be destroyed – not necessarily

**Junior Mortgage Liens**
- Mortgage Forms – transfer written in conveyance language; series of promises and covenants
- Types:
  - Refinancing
    - Aames Capital Corp v. Interstate Bank of Oak Forest
      - Wanglers first give note and mortgage to Savings and Loan transferred to Standard Bank
      - Wanglers second gave note and mortgage to another institution (Suburban)
      - Wanglers third gave judgment lien to Interstate Bank after being sued
      - Wanglers fourth gave note and mortgage to Pacific which was transferred to Aames to pay off Standard and Suburban
        - Aames claims that it takes over the position of Standard because it bought Standard’s loan
        - IBOF says they are 1st in time and 1st in right
        - 3rd party lender comes into the transaction with notice of any intervening liens – assumes the risk of intervening lenders
  - **No equitable subrogation for Aames b/c Aames was on constructive notice of judgment lien to IBOF**
    - Home Equity Loans
    - **Subordinating Seller** – Buyer is a little short of money and the Seller agrees to finance a portion of it
    - **Gap Financing** – money to live on between selling the old house and moving into the new house
    - Material men who extend credit
    - Judgment creditors
  - Risk Analysis
    - Looking to become 1st **priority lender** – value of the property as security
    - Looking to become a **junior lender** – after the priority lean holders are paid off that the property has enough value to pay you off too;
      - More important that property value = ability of the borrower to pay off the loan (borrower’s credit)
  - Dual relationship
- Junior Lienor has same relationship with mortgagor as the senior lienor
- Junior Lienor also has a relationship with the senior lienor – what happens if the senior lienor forecloses on the property
  - **Affect of senior lienor’s foreclosure = wipes out junior liens**
  - Modification of the Senior Mortgage → Guleserian v. Fields
    - Guleserian did not extend the principal by increasing it or increase interest, only increased monthly payment schedule
      - Changed the rate at which the principal was paid off – changed loan from self-amortizing to traditional mortgage (balloon)
        - 2nd mortgagee doesn’t want it’s security impaired
    - If 1st mortgagee extended more principal, that would definitely affect the 2nd mortgagee
  - Issues:
    - Whether by reason of the extension, the bank, as first mortgagee, will lose priority?
      - By going from self-amortizing to balloon, 1st mortgagee increases chance of default or decreases chance of default because payments are easier to make
    - Whether extension agreement will constitute a breach of the 2nd mortgage, entitling 2nd mortgagee to foreclose?
      - Solution: include in 2nd mortgage an express condition that the mortgagors must continue, without any extension or postponement, to make the installment payments of principal on the 1st mortgage note.
        - Include in the 2nd mortgage clause that says no changes to the 1st are allowed without the permission of the 2nd mortgagee.
  - Restatement of Mortgages = encourage lenders to work out problems with each other
- **Purchase Money Priority** = Purchase money mortgages have preferred position over prior liens such as judgment creditors and mortgages claiming under after-acquired property clauses in mortgages previously executed by mortgagor
  - Seller gives a gap loan to Buyer to provide living expenses for the Buyer who has already obtained a mortgage
    - Common Law says Seller only conveys fee simple subject to lien that Buyer pays off the gap loan – Seller never loses 1st priority position
    - Documents must reflect shift in priority from Seller to Mortgagee
    - What if institutional lender records first? Is there something that would give the institutional lender either constructive or inquiry notice of the purchase money mortgage?
      - Money never left the seller so institutional lender is on notice
      - You’d have to create a K between the seller and the lender
- **Assumption** = Transferee promises to pay on the note; Accepts deed with mortgage attached
  - 3 people involved = Lender, Borrower/Transferor, Borrower’s Grantee/Transferee (the guy assuming the loan)
    - Land = primary fund for payment
    - Grantee’s personal liability = primary fund
    - Borrower’s liability = secondary fund
  - If creditor grants extension to subsequent assumption transferee without transferor’s consent, transferor is discharged.
  - To avoid liability, mortgagor/transferor should ask mortgagee/lender for a release.
  - **Due on sale clause** = mortgagor can declare transfer an event of default and declare the whole amount due
    - Hurts alienability
    - Ok as long as it’s not unconscionable

- **Subject to** = Transferee makes NO promise to pay; Accepts deed with mortgage attached
  - **Transferor still liable on the mortgage**
  - Same 3 people involved as above with different distribution of liability:
    - Land = primary fund for payment
    - Borrower’s liability = primary fund
    - However, creditor who receives notice of transfer must observe equities – see below.
  - **Zastrow v. Knight** → lender (mortgagee) renegotiated terms of the mortgage, so the lender should bear the burden of default not the mortgagor
    - However, b/c transferee took the property subject to the previous mortgage, the court will only partially discharge the mortgagor
    - Even though Knight transferred the property and the mortgage (assumption) to 3 middlemen, those 3 middlemen were probably straw men and can not be held liable.
    - If creditor grants extension to subsequent “subject to” transferee without transferor’s consent, transferor is discharged to the extent of the value of the land properly applicable to the debt.
      - If property value is less than principal amount of loan, then transferor is still on the hook, but only to the extent of the value of the land – value of the debt (VL – VD = transferor’s liability)

- Lawyer liability = Wright v. Pennamped → Wright, a building owner, reached an understanding with SCI, a lender, for a refinancing; Pennamped, SCI’s attorney, prepared drafts of the loan documents and sent them to Brown, Wright’s attorney. Brown accepted on behalf of Wright, then Pennamped redrafted prepayment penalty to increase the amount of penalty and didn’t tell Brown or Wright.
  - Court imposed duty to disclose the redrafting – not so much an adversarial system as a cooperative system

**Mortgage Property Transfers by Mortgagee**
Giorgi v. Pioneer Trust → Mortgagor transferred note, deed of trust and mortgage to Manke who gave the note and deed of trust to Pioneer Trust (Servicing Agent/Trustee); Mortgagor paid Pioneer Trust who paid Manke; Manke transferred the mortgage but not the note to Giorgi; Giorgi informed mortgagor that Giorgi was his new mortgagee, but did not tell Pioneer Trust; Pioneer Trust continued to pay Manke

- **Note = Federal Negotiable instrument law and can be transferred**
- **Mortgage = State Recording Acts**
- **Standard Operating Procedure**
  - Mortgagor should pay only the holder of the note
  - New holder of mortgage should notify Mortgagor and Trustee that they now have the mortgage

Doyle v. Resolution Trust Corp (took over for FNMA)

- Growth of secondary mortgage market – Secondary mortgage market was meant to fix the mortgage market → attempt to protect government interest in the property by collecting on overdue notes
- Loan made by savings and loan association at 11.375% interest; in the process of transfer the interest is bumped up to 15 – 16%; Default and the borrower says I didn’t sign on to rate increase
- FNMA bought a package of loans from Trinity; Trinity changed the interest rate on Doyle’s loan without telling Doyle
  - FNMA was not on notice that the rate had been changed therefore, FNMA cannot be held responsible.
- **Holder in due course = = taking free and clear of any promissory obligations of previous party → key to secondary mortgage market**
  - K must be clear
  - K must not be changed without consent of original parties
  - Have to take for value in good faith without notice [see p. 438]; objective test
  - In determining whether holder had notice, court uses objective reasonable person test.
    - FNMA admits that it saw that the interest rate was whitened out, but they thought the change was authorized b/c the change was initialed and FNMA checked to make sure that initials were of the right name.
    - FNMA said it couldn’t be expected to inquire into the validity of the change
      - If they have to check everything, that raises costs for FNMA and consequently for everyone else.
    - I say, FNMA knew Trinity had problems or it wouldn’t have rejected Trinity’s first package
      - Good faith = subjective test; FNMA rejected the 1st package proving that they are not in cahoots with Trinity and that they are acting in good faith.

- Lawyer Liability → One National Bank v. Antonellis = malpractice action by a mortgage assignee against the attorney for its assignor (Milford)
Bank relied upon mortgagee’s attorney checking records

- Does attorney owe duty of care to Bank?
  - Court says no under foreseeable reliance doctrine = other side can rely only if the imposition of the duty of care would not potentially conflict with the attorney’s duty to his or her actual client
  - Conflict between confidentiality and candor
  - Conflict of interest between attorney’s client and other party

Foreclosure = if done properly, cuts off equity of redemption belonging to the mortgagor and wipes out all junior interests

- Priority example
  - Easement - S (W.D) → B – Note and mortgage to M1 (20K) + Note and 2nd mortgage to M2 (5K) (lease) → T
  - Priority order = Easement holder, M1, M2, T

  - **Strict Foreclosure** = mortgagee can take either possession and title to the property, or the proceeds of sale of the property to a 3rd party, and a claim for the balance due.

- Died in US in 19th Century in large part b/c of Civil Procedure Reform

- **Judicial Foreclosure & Sale** = can take time and cost money in attorney’s fees; unusual notice requirements; sale proceeds distributed by court
  - Key to eliminating junior lien holders = join them as necessary parties to the foreclosure suit

- **Non-Judicial Foreclosure & Sale** = sale process delegated directly to Trustee in DOT, in mortgage with power of sale it’s delegated to mortgagee; risk of mistake is greater

  - Key to eliminating junior lien holders = provide juniors with notice

  - Rosenberg v. Smidt → sent notice of foreclosure to wrong address

    - “Last known address” = that address most likely to give notice and must be obtained through due diligence
      - Would not have taken much work to discover new address – could have found it in the phone book.
      - Increases cost of the process
      - Increases time of the process
      - Helps borrower who stands to lose a lot, even though it hurts lender who stands to lose very little.

    - Result of failure to perform due diligence = depends on whether sale was a void (treated as though transfer never occurred) or voidable sale (depends on the equity of the situation, transfer may have occurred or may not have occurred) → SEE DEED ABOVE

- **Deed in Lieu of Foreclosure** = No more note or mortgage if mortgagor hands over the deed; merger issues

  - Defaulting borrower and the lender agree that they will end the transaction by the borrower handing over a deed to the property and the lender will give up any default judgment

  - Concept of equity of redemption goes against the express intent of the parties reflected in the mortgage
May be a better approach than foreclosure when default occurs in a declining market

Clouds title – if there are multiple mortgages, the mortgagee that receives the deed has fee simple subject to lien of junior mortgagee

- Doctrine of merger destroys 1st mortgagee’s mortgage b/c the deed merges into the mortgage and gives the junior mortgagee first priority
  - most courts reject this and say 1st mortgagee gets equity in the property and junior lien holder retains its junior status

Rule against **clogging the equity of redemption** = once a mortgage, always a mortgage

- Once the interest has been created, the mortgagee has to live with the rights of the mortgagor created by the interest
- **“Time is of the essence” clause** = designed to limit ability of parties to delay completion of agreement = clog
- Shared appreciation mortgage (fixed rate of interest + percentage of any appreciation) = clog b/c should be able to redeem the entire interest if the loan is paid off
  - Not a clog if the shared appreciation is “reasonable”

- Deed in lieu of foreclosure = clog?  
  - No b/c this is a subsequent agreement to the mortgage

**Statutory Redemption** = even though Foreclosure cuts off equitable redemption, statute may make redemption possible

- Matcha v. Wachs  
  - see handout for facts; Savings and Loan crisis of the 70’s
    - Matcha (4th priority) claims that Wachs (2nd priority) did not comply with the statute of redemption  
      - too late and filed copies instead of originals
    - Wachs claims that it “substantially complied” by filing notice to the sheriff on time – court buys this argument
      - Notice document was critical – after notice was turned in, Wachs substantially complied even though he filed too late
      - Because Wachs complied with the statute, Matcha would have to buy Wachs’ lien for $600K+

- 30 states have this provision
- Courts will allow waiver, but only in certain circumstances
  - Clog on equity of redemption?

Other attempts to protect real estate consumer when there is a default

- **Fair Value Rules** = If you get fair value through a foreclosure sale, that’s enough; spread risk between borrower and lender
  - Similar to bankruptcy code

- **One-Form-of-Action and One-Action Rules** = if you have a note and a mortgage, you have 2 causes of action (breach of K on the note or foreclose through the mortgage), not if these rules in place
  - Forces lender to make a decision between foreclosure or breach of K on the note
- Shut down or modification of foreclosure process for a period of time when the market is down – done during the 30’s and the late 70’s in farm states
  - Requirement of mediation before foreclosure

**Deficiency Judgments**

- **Anti-deficiency legislation** = consumer protection statute, ½ the states have enacted these statutes
  - Policy behind these statutes = discourage overvaluation of land and encourage more accurate assessments of what the real value of land is in a community – dampen inflationary real estate market
    - Do these statutes accomplish this purpose? ⇒ Won’t lenders cover cost of the risk by charging premium for the loan? 3 ways to cover cost:
      - Higher down payment
      - Higher interest rate
      - Higher sale price for the property = opposite of what the statutes are intended to control

- Cornelison v. Kornbluth
  - Cornelison ⇒ Chanons (default on note) ⇒ Kornbluth “subject to” ⇒ Larkins (default)
  - As result of foreclosure sale, Larkins ⇒ Cornelison
  - Cornelison sues Kornbluth for damages after sale
  - Issues:
    - What’s the affect of the “subject to” clause? ⇒ transfer of mortgage property subject to a mortgage means that the person who takes under “subject to” is not personally liable for the note (no promise to pay)
    - Does the “subject to” clause **insulate the mortgagor not only from the note but from the covenants** (promise to pay taxes, to care for the property, etc.) outlined in the mortgage?
      - Due on sale clause = promise not to sell the property unless the seller can pay off the note
      - If **property interest, the covenants “run with the land”** – however, this **depends on intent** of the transferee
        - If the transferee doesn’t intend to accept the covenants, then the covenants shouldn’t run with the land.
        - Ground leases as financing devices – if ground lease and mortgage are considered parallel devices for financing, shouldn’t the rules be the same for both?
          - If there is a “subject to” clause, the ground lease may be more beneficial to the lender.
    - Kornbluth had no duty to comply with the covenants
What is the impact of the anti-deficiency statute? – **Can’t get deficiency judgment against D under the note.**

- Is the anti-deficiency statute overruled by waste?
- **Waste** = hurt the property; duty is to protect the value of the property
  - **Waste in this context = a deficiency judgment**
    because Cornelison has already foreclosed on the land
- Shouldn’t defaulting borrower be responsible for the waste?
  - Waste (Property – **good faith waste**) = borrower can’t pay to increase value of the property
    - **Protected by the anti-deficiency statute**
  - Waste (Tort – **bad faith waste**) = borrower recklessly or intentionally hurt property value
    - This is the definition of waste the court adopts because the anti-deficiency statute is designed to cushion the impact of economic decline. It’s acceptable for a borrower to be punished for default by losing the property, but it’s unacceptable to add insult to injury by coming back and suing them for default after foreclosure.
  - **Borrower is not responsible for the actions of the market, but is responsible for borrower’s own actions.**
  - **Not protected by the anti-deficiency statute**
    - **Full credit bid** = Creditor bids exactly the amount the creditor is owed under the note
      - Paying off the note is enough to end discussion of waste
      - Property is worth the amount of the bid because creditor bid that much, therefore the property value has not decreased

**Land Sale Contracts**

- Buyer can get possession with little money down (sometimes no money down); seller doesn’t have to get an appraisal, can raise sale price, may enforce interest as a lien and retains title to the property
- Relationship **appears more like a landlord-tenant relationship** (lease with option to buy – low income housing tax credit = financing for low income apartment dwellers)
  - **Section 8 Program** = convert rental subsidy program to a lease with option to buy – Bush Administration
- Interests created:
  - Buyer promises to pay installments
  - **Buyer gets possession now, but title later** = different from marketing K where possession doesn’t transfer until all payments are made
  - Buyer has **vendee lien**
  - Seller promises to transfer title after all installments are made
  - Seller has **vendor lien**

  **Skendzel v. Marshall** → Installment land K in 1958; $36,000 in $500 installments; Buyer pays more than installment requirement for 7 years ending when Buyer died; when B died she had paid $21,000.

  - Court chooses to **treat installment K as a mortgage** b/c “equitable title vests in the vendee at the time the contract is consummated” even though legal title doesn’t vest until all the installments are paid – transfer of possession consummates the sale
    - When property law was in its infancy, when Buyer got a Mortgage, he conveyed title to the mortgagee = same situation
    - Equitable title creates a vendee’s lien in the Buyer and a vendor’s lien in the Seller
    - Foreclosure is required = foreclosure of vendee’s lien on the property
  - In normal foreclosure process where the defaulting buyer had paid down a $36,000 mortgage to $15,000, the buyer would be compensated for anything over $15,000 that the house sells for.
    - If this buyer had defaulted after paying down the installment contract only $3000, then it would be inequitable to the seller not to enforce the installment K

  **Dirks v. Cornwell**
  - Butler → Cornwell with an installment land K; Cornwell gets $38,000 loan from Goodwill with home as security for the loan; Goodwill records mortgage
  - Cornwell defaults
  - Butler sells to Dirks
  - Dirks files quiet title action
  - Goodwill says no fair we have an interest in the property
  - Does Buyer in land installment K have sufficient interest in property to mortgage it?
    - Yes - **Buyer has possession and vendee’s lien → can give that away**
  - Can Seller put clause in K to stop B from borrowing on his possession and lien?
  - **Mortgagee’s recording mortgage is not enough to give Seller notice** because the recording act only gives notice to future buyers, so there is no obligation on Seller’s part to look at it.
    - Mortgagee has the duty to give actual notice to the Seller
  - Dirks didn’t have notice because Goodwill’s mortgage was out of the chain of title.

**Tax Planning – Capital Gain**
- IRS breaks property into 3 classes:
- Property held for investment or production of income
  - § 1221 = Capital asset
  - § 212 deduct expenses
  - § 167 deduction for the depreciation of improvements situated on land
  - § 1031 tax-free exchange will postpone recognition of gain or loss on transfer of the property
  - **Investor** = someone who holds property for investment or income

- Property used in trade or business
  - § 1231 = gain is a capital gain; loss is treated as an ordinary loss
  - Expense deductions, including the depreciation deduction
  - § 1031 tax deferral is ok

- Property held *primarily* for sale to customers in the ordinary course of trade or business
  - Ordinary gain + ordinary loss
  - Expense deductions but NOT depreciation deduction
  - No deferred recognition of gain or loss under § 1031
  - **Dealer** = someone who holds property primarily for sale in the ordinary course of trade or business

- Development process concerns tax treatment of 1 and 3 above – How to distinguish the above classes?

- Malat v. Riddell → joint venture wanted to develop and operate an apartment project or sell it if they can’t develop it; bought property; subdivided part of it and sold the subdivided part then kept the rest of the property to develop it; weren’t able to develop that which they kept so they sold it as a chunk and wanted to claim the second segment that was sold was held for investment
  - **Primarily = of first importance or principally**
    - Allows for multiple purposes
    - Simultaneous purposes are possible

- Biedenharn RealtyCo., Inc. v. United States → Family run realty holding corporation bought land for farming and future investment; over 40 years, they sold portions of the property in a variety of ways
  - Biedenharn bought the land for investment purposes = started as an investor; but then the holding corporation became a dealer that was holding property primarily to sell to customers
  - Main factors in determining classification of property – **factors** that led court to determine that Biedenharn was a **dealer not an investor**:
    - **Frequency and Substantiality of Sales** – most important factor
    - **Improvements** – adding streets, sewerage and utilities is something you do to prepare for sale
      - Can cut the other way because improvements can maximize investment value as well as sales value
    - **Solicitation and Advertising Efforts** – developing the infrastructure for a future subdivision constitutes advertising
    - **Broker’s Activity**
Way to get around investor/dealer distinction = investor buys property and do the initial groundwork for development (things like plat division and recording) then the investor sells the property to another developer that acts like a dealer, finishing the development and selling the land → how it is done in KC

Tax Deductions
- § 167 = Depreciation Deduction
  - Land is not depreciable, only buildings and other improvements are.
  - Taxpayer gets to decide what the useful life of the building is used in the depreciation schedule.
  - Residential real property can be depreciated over 27.5 years
  - Commercial real property can be depreciated over 39 years
  - Straight line deductions = pro rata ROC; no longer use Double Declining Balance Deduction which was a ROC first scheme – this disallowed by 1986 Act
  - Investor more interested in depreciation deduction – will pay to obtain deduction; deduction can be sold to investors just like the low income housing tax credit
    - Tax credits sold for 70-90 cents on the dollar
  - Computing depreciation deduction:
    - Determine basis of investment by aggregating the cost of the land and improvements, including the amount of any debt secured by the property and transaction costs
    - Identify part of the basis allocable to depreciable assets (land value is not depreciable)
    - Assign useful life of improvements (Residential = 27.5; Commercial = 39) + salvage value
    - Total improvements value – salvage value = depreciable basis
    - Depreciation deduction must be taken as a straight line deduction
  - Building has $5 mil. FMV; $1 mil. of equity investment + $4 mil. of non-recourse loan (not personally liable on the loan – remedy available to lender is limited to foreclosure sale in case of default – no deficiency judgment and no personal liability)
    - Basis = Cost; What is the basis here? - $5 mil. b/c that’s how much the building costs or $1 mil. because that is the amount you put forward?
      - Crane says non-recourse loan debt can be added to the basis even though there is no personal liability as long as there is a legitimate transaction underlying the loan
      - Cost to develop the property should be deductible
  - Tufts → upon disposing of the property a few years later; $1.85 mil. non-recourse loan; basis = $1.45 mil.; FMV = $1.4 mil.
    - TP claims a loss of $55,000
    - IRS says TP actually gained $400,000
    - Meant to motivate people involved in this transaction to invest enough money in the property to keep it up
Estate of Franklin → Court does not recognize sale leaseback of a home; there must be some connection between amount of debt and fair market value of property.

1986 Tax Act – At risk limitation
- Meant to limit non-recourse financing
- Qualified non-recourse financing = nonconvertible debt to an independent third party lender regularly engaged in the business of lending money or to a governmental agency
  - This is acceptable, but the other types of non-recourse financing are not

Disposition – Like-Kind Exchanges
- 1031 → Like-kind exchanges
  - No gain or loss recognized on exchange of property of like kind or use
  - **Nature** of the property, rather than its use or value, is key item
    - Fee simple v. leasehold interest
    - Income producing v. non-income producing
  - Rights of respective grantees to the property exchanged must be of the same general character or substantial equality
    - **Ground Lease of 30 years or longer is functional equivalent of fee simple**
      - Control is what is important not fee simple necessarily
    - Fee simple is NOT a lease
  - **Basis of property acquired is that of property exchanged!**
    - If boot, Basis in new property = Basis in Property exchanged – Value of boot + Gain recognized
  - **If boot, gain recognized up to value of boot.**
    - No recognition of loss ever!
  - Starker v. US → **simultaneous transfers not required** under 1031 so long as transfers occur “at or about” same time. (1984 amendment: identify within 45 days or receive within 180 days)
  - Biggs v. IRS → series of transactions qualifies as one exchange if part of integrated plan
    - **Title to exchange property does not have to be acquired as long as K right to assume obligations of ownership.**
  - Revenue Procedure 2000-37 → Exchange Accommodation Titleholder (EAT) = parking; safe harbor
  - Affect of transferring property with a mortgage attached = **Transfer of property subject to a mortgage, with or without assumption of the personal liability, is considered as money received (to the extent of the liability – 1031(d))** – mortgage does not need to be assumed (i.e. transferee need not assume personal liability for the mortgage)

Commercial Land Finance – Mortgage Terms
- Interests:
  - Land Owner/Seller
    - Tax consequences
    - Cash value
Security interest in case of lending – priority in the case of default
  • Credit Check on Developer/Buyer

**Subordinated Purchase Money Financing** = seller agrees to subordinate his purchase money mortgage to the Construction Lender and the Permanent Lender’s mortgages/liens
  • Subordination = a change in status; seller is no longer the primary lien holder
  • Subordination by 2 ways:
    o **Agreement** = K may not be enough; + reconveyance of title then rerecord after lender records his mortgage
      ▪ Is the K specifically enforceable? – clean hands?
      ▪ Is the relationship solely between the seller and the buyer, or is it a three party transaction including the lender?
        • If so, what are the obligations of the lender to the seller?
        • Middlebrook-Anderson v. Southwest → **Construction Lender has an obligation to manage funds to make sure they don’t get subverted.** If they haven’t, then the subordination agreement cannot be specifically enforced against the seller.
    o Example Agreement = p. 289 – supp.
      • Parties = owner, buyer, beneficiary
      • Definitely written by the Construction Lender – Lender acquires no duty to make sure buyer uses its money correctly → “Beneficiary declares… (b)...”
      • Consideration for Seller’s agreement to subordinate = the building will not be made without Construction Lender’s Loan, and Construction Lender will not make loan without subordination.
        o **Automatic** = wait until construction lender records his mortgage before the seller records his purchase money mortgage

  o Developer/Buyer= Control and Leverage
    ▪ Leverage = use small amount of your funds to attract large amount of someone else’s
    ▪ Needs money now, but doesn’t have it
  o Construction Lender = short term lender to get the project going
    ▪ Building must get built on time, within budget, etc. b/c we are undersecured
• **Draw Inspector** = Agent of the lender who supervises of construction
• Make sure contractors are **bonded** – Bonds are like life insurance, good if the project dies, but not so good to save a sick project.
  o Better to get a well-financed, long-established contractor whose assets will guarantee performance

- Security = how the building is built
- Priority
- Paid off or “taken out” = Balloon
  - Short term investment in the property
  - Don’t loan more than justified by work done
  - **Take out Commitment for Permanent Loan** = Construction lender won’t commit until Permanent Lender commits to take the Construction lender out

- **Riskier than permanent loan** b/c appraisal is based on pieces of paper and has no assurance that strikes, increased construction costs or natural disasters will not make the project more expensive than originally contemplated
- Must have access to a permanent lender that will take them out of the project – permanent lender must be happy
- To protect against risks:
  - Make sure the draw inspector is a licensed engineer
  - **Retainage** = withhold percentage (5-10) of estimated cost of work in place
    o Contractor will often inflate claims to cover costs above retainage
  - **Lien waivers** = short as legally permissible and always include a description of the work done for the current claim, the total amount paid to the recipient to date, the amount now claimed, the amount of retainage, and a release for all work done and payments made to the date of the lien waiver.
  - **Conditional Disbursement**
  - **Record Construction Loan before First Spade Rule** = protects against mechanics liens
    o Permanent Lender = takes over Construction Lender’s loan after Construction Lender has been “taken out”
      - Priority
      - 1st Lien
      - Security = Property Management must be good b/c that’s where the income comes from
      - Proper terms
    o Contractors/Subcontractors
      - Payment on time or ASAP
        • Risks of liability
        • Risk of non-payment
- Lien Power = give notice to mortgagee of liens
- Priority – Make Developer post a bond
- Security interest in the property
- **Mechanic’s Lien Law** = consumer protection from the common law – made for the protection of the supplier or worker that has benefited the owner of property without payment → mechanic has the power to foreclose on the lien just like the mortgagee has power to foreclose on a mortgage
- Williams & Works v. Springfield Corp.
  - “**Commencement of building**” = act upon the ground constituting beginning of the building = **actual, visual work on the land such that it was apparent to all that a building was being erected or improvements were being made.**
    - Installation of outdoor irrigation systems
    - Engineer drawing specs does not constitute commencement of building
    - Uniform Construction Lien Act provides a **Notice of Commencement** that the owner must file – Commencement of the building has begun on the date the Notice of Commencement is filed
  - What is a lienable service? → off-site drawing of plans is a lienable service b/c it constituted an improvement of the property
- Hypothetical – assume mechanic’s liens were filed in Michigan – who has priority? – when has commencement of the building began? - what should be considered preparation for commencement of work?
  - Construction K signed (11/5)
  - Survey staked out (11/10)
  - Brush cleared (11/12) – not necessarily notice of construction of building – could be done to prepare a field for planting
  - Ground breaking (11/15) – who’s doing the work here?
    - **First spade rule** = first time a shovel enters the ground and turns the dirt constitutes the commencement of building
    - More or less gives control to owner over who has priority in case of default
  - Construction Loan recorded (11/16)
  - Excavation for building foundation began (11/18)
- Perfection of Lien
  - First, file notice of lien with clerk or recorder (w/in 6 months of doing the work in MO).
Then, file the lawsuit to prove 1) there was an enforceable contract, 2) you did the work, 3) you weren’t paid.

- Lien Waiver: General contractor must give notice to land-owner that subcontractors will be employed and retain right to lien if general doesn’t pay up

- 3 stage process:
  - Land acquisition stage – pre-development – Due Diligence
    - Is the project financiable? Will I be able to obtain the funds necessary to accomplish the project?
    - Is the project feasible? Will I be able to pay back what I borrow and make money off the deal myself?
  - Methods of Land Acquisition
    - Cash
    - PMM
    - Conventional Mortgage
    - **Wrap-Around Mortgage** = got some money, but we need some more; second mortgage securing a promissory note, the face amount of which is the sum of the existing first mortgage liability plus the cash or equity advanced by the lender
      - Purpose is to take advantage of the tight money market and the high cost of borrowing
      - Already have a 1st mortgage of $400K with 8% interest; need $200K more; can afford to pay $60K/year; 1st Mortgage costs $32K/year
      - Wrap-Around (WA) mortgage (junior) of $600K only $200K would be disbursed; all $60K goes to WAMee who pays the first mortgage off $32K/year and can receive as much $28K/year
      - Risks:
        - WAMee does not pay the 1st Mortgagee
        - WAMee’s Junior status
        - Could trigger due on sale clauses and pre-payment penalties
  - Ground Leases
  - Installment Land Ks
  - Tax Increment Financing (TIP) = Property taxes are collected, but allocated in different ways – existing property taxes are allocated as usual, but improvement property taxes are used to fund the redevelopment of roads, etc.
    - Infrastructure subsidy
  - Transportation Development District (TDD) = Hanley and Eager; another way to fund the infrastructure; separate district with authority to charge separate sales tax to fund infrastructure
Option to do any one of the above

McElroy v. Grisham → What distinguishes a sale from a mortgage?

- O → McE 104 acres for $240K
- McE has financial difficulties and looks to G for a $100K loan
- McE → G – warranty deed
- G → McE - $80K + option to repurchase property for $120K ($40K in one year + $80K the next year)
  - McE cannot make the first $40K payment so G and McE engage in a K for Deed or an Installment Land K
    - $16K now and 109K in installments + 10%
- Usury = whether the lender knowingly entered into a usurious K intending to profit by the methods employed
  - Usurious rate in this case changes over time; in late 70’s usury challenges became quite frequent because interest rates rose above 10%
  - The transaction must be re-classified as a loan for the usury laws to apply
  - 4 elements:
    - An agreement to lend money
    - Interest in excess of that allowed by statute – interest = charge imposed for the use of money
    - Absolute, not contingent, obligation to repay the principal
    - An intention to violate the usury law = intention to profit from a transaction that violates the law (doesn’t matter whether you know the transaction violates the law or not)
  - Corporate Borrower exemption = creating a corporation to borrow the money at an extremely high rate; corporation must be a viable entity
  - Time-Price Doctrine = seller financing through a PMM is paying for the service rather than money; no money exchanges hands, so it’s not a loan, consequently PMM’s are not subject to Usury laws
- Sale or mortgage? – Mortgage if:
  - Seller/Lendee’s financial troubles – requesting loan
  - Seller/Lendee’s expressed intent to keep the land
  - The substantial disparity between what Seller/Lendee paid for the property and the purchase price
  - Lender’s immediate renegotiation of a contract for deed when it became apparent Seller/Lendee could not “exercise his option”
- Actual Construction – begins with Permanent Loan take-out agreement
Financing the Construction:
  o Construction Loan
    • KislaK Mortgage Corp. v. William Matthews → characterization of future advances as optional or obligatory
  • Construction Lender (P) paid Developer (D) who never paid the subcontractors (intervenor)
  • Construction Lender forecloses on the property – who gets priority? – CL (P)? or Subcontractor?
    o Mortgage lien usually takes priority over mechanic’s lien except when a construction mortgage provides for progress payments over a period of time and some of the disbursements are voluntarily made at a time subsequent to the effective date of the mechanic’s lien.
    o Mortgage lien gets priority b/c K obligates mortgagee to make the payments.
    o Subcontractor says mortgagee is not really obligated b/c they could withhold payment if the draw inspector comes back with a negative report.
    o If mechanic files lien before mortgagee makes voluntary advancement and mortgagee makes advancement knowing about mechanic’s lien, then mechanic’s lien takes priority.
      • Optional or obligatory?
        – more safety factors put into effect to protect against the risks that the money will be used incorrectly = more prove that the payments are optional not obligatory
      • Relation back theory = liens should relate back to the commencement of construction.
Permanent Lender – should examine plans and specs in advance and insist that the building be constructed according to those plans and specs

- Must have architect or engineer inspect building plans and development – reduce costs by using same engineer or architect that Construction Lender uses
- Construction lender will approve changes that are unacceptable to the PL b/c the CL wants to get his money fast and get out

**Buy-Sell Agreement:**

- Consent of PL to the assignment by the borrower to the construction lender of the proceeds to be forthcoming under the permanent commitment
- Define “completion” = mostly “substantial completion” = Not 100%
- Agreement of CL to sell the loan to no one except the PL and to refuse to accept prepayment
- Agreement of PL to buy the loan at par, subject to compliance with the commitment
- Remedies in the event of the borrower’s default under the building loan agreement or under the permanent commitment
- Agreement of the borrower to comply with the permanent commitment and to amend the mortgage documents if the PL requests it, and the agreement of the CL to obtain such amendments from the borrower

**Post-Construction - Operational stage (building is finished, now sell or rent it up and pay off all loans in the process)**

- Permanent Lender
  - Penthouse International, Ltd. v. Dominion Federal S&L
    - what constitutes “anticipatory breach”/anticipatory repudiation
      - Developer has deep pockets, has building 55% complete and then attempts to get financing
      - S & L gave combo construction and permanent loan ($97 mil.)
      - S & L sold 1/3 of the loan to Dominion; valid 1\(^{st}\) mortgage on improvements + leasehold interest; conditions (692-93) = title insurance policy –
too strict a policy required so it turned into a deal breaker, getting utilities – used to determine net operating expenses and was not done, written approval of plans and specs, approval of construction Ks with contractors, approval of loan participation

- Dominion takes participation agreement twice its legal limit and then has to turn around and sell it
- 695 – Original commitment date in the fall extended to Dec. 1, 1983; close loan no later than Feb. 1, 1984 or later than March 1, 1984 = when is the date of performance (can’t repudiate until you are obligated to perform)
- 696 – Penthouse’s argument = we’ve already finished ½ of the building, so we’ll get a certificate of approval from our own engineer instead of an independent engineer
- Dominion’s lawyer said the documents were bad and the whole project had to be rewritten
- Project fell apart because mortgages were attached to the leases; 14-15% interest rates; huge commitments by lending agencies
- Liability of 3rd parties → lenders could become liable for defects in the condition of building or land if they got too involved in the development
  - 2nd Circuit rejects 3rd party liability in this case.
  - Lender was able to argue successfully that it shouldn’t be liable for the project falling apart b/c Lender was just trying to hold plaintiff to the conditions of closing in the lending agreement – set a date by which developer had to obtain title insurance and utilities; developer did not satisfy conditions by the specified date so the closing never happened.
  - Lender did things right, so courts didn’t have to back away from lender liability
  - If lender does not follow usual lending practices, it could be subject to liability.
- Is the lead lender authorized to act as a general partner and make commitments for all of the other lenders? Is lead lender’s job just an
administrative position meant to oversee project?

- Participation Agreement limited lead lender’s authority to supervision not the ability to waive compliance with closing provisions.

- Major v. Minor?
  - Lack of title insurance and utilities were NOT minor; neither was the fact that Dominion would have had to take a junior priority status.

- Role of attorneys
  - As expert witness? Expertise solely on the law? If so, aren’t the attorneys trying the case the experts making the additional expert unnecessary?
    - Nelson testified to the fact that the conditions could not have been met in time.
  - Hard to balance responsibility to close transaction with responsibility to protect client.

Ground Leases/Leasehold Mortgages

- Ground Lessee/Developer
  - Greater leverage – can add financing problems unless right to mortgage fee is included.
    - Minimize cash investment – may only have to put down one month’s rent
  - Have his leasehold interest treated like fee title
    - Right to alienate (make sure lease is freely assignable)
    - Few use restrictions
    - Duration for the useful life of the property – at least the length of the mortgage (30 years)
      - IRS considers 30 year lease = fee simple for purposes of § 1031
  - Short term defaults should not jeopardize his leasehold interest
    - Security instrument is destroyed upon eviction unless the Lender gets to put the mortgage on the Lessor’s fee interest in the property
  - Recover value of lease and improvements if eminent domain or destruction – access to insurance
  - Economic health of lessor (no bankruptcy)

- Ground Lessor
  - Summary eviction is preferable to usually longer foreclosure proceedings b/c it is much quicker
Defense to summary proceeding use to be “I paid” – now not so fast b/c there are many new defenses (warranty of habitability, retaliatory eviction, etc.)
  - Tenant’s good economic health so that rent, utilities, taxes, etc. can be paid
  - Tenant’s rental payments feed the mortgage
  - Flexibility in rental structure to keep up with inflation
    - Escalator = periodic rent adjustment based on re-evaluation of property; requires careful description of reappraisal process
      - Step-up clause = rent increased at pre-arranged intervals; dangerous b/c value of land may increase faster than the escalator
      - Index clause = rent increased based on cost of living index
- Space Tenant/Sublessees = people who are paying the rent
  - No use restrictions in lease that will prohibit intended uses – ground lease doesn’t prohibit their use
  - Freedom to assign
  - Ability to cure tenant (sublessor) defaults – want to be able to step in and pay for the developer’s default
  - Right to exercise tenant’s (sublessor’s) renewal option if tenant fails to do so
  - Sufficient length of master lease to cover sublease.
- Fee Mortgagee who wants to subordinate the Ground Lessee’s mortgage
  - Security is product of the real property interest in the land (fee simple) and the economic success of borrower’s operation
    - Balch v. Leader Federal Bank \(\rightarrow\) Subordination Agreement
      - Language of the agreement is critical; “lease” used at one time and “fee title” used at another time, when the same term should have been used consistently throughout.
      - 3 settings:
        - Mortgagee-Lessor (subordinated Ground Lease), lessor mortgages its reversionary interest
        - Mortgagee-Lessee (unsubordinated Ground Lease, lessee mortgages its possessory interest)
        - Lessor-Lessee (lessee agrees to subordinate to after-acquired fee mortgage)
      - Ground Lessor joins in the mortgage but not the note
      - Ground Lessor agrees to “pledge” his reversionary interest (subject to) as added security
        - Make sure this is self-executing
      - Subordination of the Ground Lease is essentially a mortgage of the fee; record lease after you record mortgage
        - Ground lease to be subordinated to maintain priority
- Leasehold Mortgagee = making loan solely on the strength of security interest in the ground lease, reversionary interest of the ground lessor is not the security
  - Security comes from property interest in lease and economic success
  - Interest is subject to defense
o Assignability of Ground Lease (a) to Mortgagee or (b) to foreclosure sale purchaser
  ▪ Deed in lieu of foreclosure = equivalent
o Right to take over defaulting borrower/lessee’s business
o Leasehold Mortgagee wants 1st Lien position – How do they get it?
  ▪ Objections = loss of priority; effect of foreclosure sale on rights of the junior mortgages
- Drafting the Ground Lease
  o Strict disbursement program – make sure someone is ensuring that building is being constructed per specs
  o Notice clauses
  o Opportunities to cure defaults
  o Non-disturbance clauses = No new developer, etc.
  o Attornment clauses = agreements to become lessee of a stranger (lessor’s successor)
    ▪ Quid pro quo of non-disturbance clause
o Assurances of continuation = shopping center will continue operation; utilities, security, snow removal, etc.
- Type of Lease:
  o **Net Lease** = Lessee is obligated to pay rent, real estate tax, insurance premiums, maintenance and repair, and other costs

**Sale-Leaseback** = 2 transactions: (1) sale and (2) long-term lease
- Steps =
  o Sale-leaseback commitment
  o Permanent Loan Commitment
  o Interim loan (acquisition & construction)
  o Sale/Leaseback executed (after construction completed)
- **Developer (Lessee)**
  o Leverage (approaches 100% financing
  o Tax Benefit (rental payment fully deductible, includes principal and land value as well as interest)
- **Purchaser (Lessor)**
  o High risk of loss
  o Tax shelter (depreciation, const. int., etc. deduction)
  o Hedge against inflation (property value appraised, rent-increases & percentage)
- Can be **recharacterized as an equitable mortgage** from Purchaser/Lessor to Developer/Lessee b/c:
  o **Repurchase Option** – to avoid characterization as mortgage, repurchase option must include
    ▪ Price of property when it is repurchased must be approximately the **FMV at the time of acquisition** – repurchase price equal to the original selling price, or the original selling price plus an inconsequential premium is likely to be recharacterized
- Longer lease term makes repurchase unlikely and increases likelihood of transaction being considered a legitimate sale-leaseback
  - Frank Lyon v. US → sale-leaseback where Lyon is the investor and Worthen is the lessee for 76 years and subordinated to mortgage
    - Option to repurchase for an amount equal to Lyon’s $500K equity plus 6% compound interest and the assumption of the unpaid balance of the mortgage – essentially all Lyon gets out of the deal is a tax deduction
    - Also, Worthen contracted for insurance proceeds and took all benefits of ownership
    - Government loses little revenue if any based on the classification of the transaction as a mortgage or a sale-leaseback
  - Factors to conclude transaction = sale-leaseback:
    - Option to repurchase was required by the State Bank Department
    - Genuine multi-party transaction based on an objective analysis of the economic benefits of the transaction independent of tax considerations
      - Several financing organizations made formal, competitive bids on the transaction
      - Lyon’s independence from Worthen
      - Lyon alone was liable on the notes
      - Reasonable rents and option price
      - Risk of building depreciation on Lyon
        - Lyon’s risk if Worthen defaulted:
          - Dissent says only 2 risks = (1) risk of Worthen’s insolvency like all lenders and (2) risk that Worthen may not exercise its option to purchase at or before the end of the original 25-year term.

Shopping Centers
- Assembling = getting access to all the divided tracks
- Staging = setting the property up for future expansion
- Inducing tenant to lease land and build its own building
- **Reciprocal Easement Agreement (Operating Agreement)** = Use of the land agreement

Distressed Property – Workouts
- Lender’s Remedies
  - Foreclosure = How soon can the Lender get possession of the property?
    - After a judicial proceeding or non-judicial proceeding of foreclosure
    - Wait until statutory redemption period is up also – can be as long as a year
  - What happens to property in the interim? Alternatives before Foreclosure in Mortgage situation
- Could write in appointment of receiver into Loan documents – in essence constructive possession - however, court has to ultimately appoint the receiver
  - Note = promise to pay
  - Mortgage = remedy in the case of default – write it into the mortgage
  - **Receiver** = someone appointed to collect and apply the rents that the property produces as an alternative to delivering the rents directly to the mortgagee
    - Somewhat difficult to get receiver appointed – must prove impairment
  - Institutional lenders don’t like this either b/c courts have considered this the lender stepping into the shoes of the developer (lender incurs liability of developer)
- Pre-foreclosure rights → allows Lender to step in before foreclosure
  - **Assignment of Rents** = don’t pay the landlord, pay the lender directly in case the landlord begins to default
    - Notice must be given in timely fashion to tenants
- **Deed in Lieu of Foreclosure** → potential for claim of fraudulent conveyance if bankruptcy ensues
  - Junior liens are still attached to the property, so now the Lender is liable to junior lienors
  - Title Insurance Co. may not insure that kind of deed.
- Voluntary process – cannot be forced on someone

- Alternatives under Ground Lease
  - Clause allowing landlord to cancel lease or have some other remedies prior to bankruptcy
    - Lease of tenant = something of value that is part of the bankruptcy estate; debtor-in-possession can:
      - Assume lease
      - Assign lease
      - Reject lease
  - Eviction

- **Workout** = restructuring of loan to allow property to ultimately become self-sufficient; usually occurs before foreclosure and/or bankruptcy; usually occurs when there is a good chance that the property will become profitable in the near future
  - Key elements of development:
    - Property – must be of value (i.e. completed office or shopping center)
    - Contracts
      - Rights
      - Responsibilities
  - Workout involves modification of rights and responsibilities – Developer assigns rights and responsibilities to Lender or to another party
  - Developer must decide initially whether to stay in or get out.
- Get out = deed in lieu of foreclosure; friendly foreclosure → gives protection of foreclosure process, but developer does not contest things, will cooperate and make things faster for the lender
- Stay in = restructure loan → modify payments (delay, change amount, change interest rate, change period of time for principal payments); new loan K; deed in lieu with understanding that title will be reconveyed once property is back on its feet; sale-leaseback

  o Interests:
    - Lender
      - Protect Security – ensure income production
        - Take possession
        - Seek receiver
      - Personal recourse
      - Get property re-appraised
      - Make sure Title is clear
      - Avoid Developer’s liability
    - Developer
      - Bring in another lender
      - Protect their investment
  
  o Example of things involved in workout
    - Advance for Taxes
    - Accept reduced payments until new leases start = moratorium
    - Bring Junior Mortgagee into discussion to reduce risk of loss of priority
    - Assignment of Rents
    - Escrow to protect next year’s taxes
    - Once leases begin, increase payments until deficit is recovered
    - Share of income – equity ownership
    - Problems → potential lender liability – environmental issues
    - Does Developer want to stay in? – if no, deed in lieu

**Bankruptcy**
- **Bankruptcy** = separate federal statutory regime that has a major impact on State property law
  - Chapter 7 = straight liquidation – no substantial assets and the debtor just wants to start over
  - Chapter 9 = Municipality liquidation
  - Chapter 11 = Business reorganization – point is to buy time while re-financing is obtained
  - Rare for trustee to be appointed, instead debtor continues to operate the business as a “debtor-in-possession”
  - Simply filing (dropping petition for bankruptcy off at court house) imposes automatic stay on any lien enforcement including power of sale foreclosure
• Provides Debtor with substantial leverage to bring Lender to bargaining table
• Psychological cost of publicly admitting failure
• May mean staying in business without being able to get more loans and without being able to convince contractors to work with you in the future
• Creditor will file a “Relief from Stay” followed by Debtor claiming they will provide “adequate protection” (evidence of insurance, property maintenance, etc.)

  § 3 main provisions:
  • Classify Claims
    o Secured
    o Priority unsecured
    o General Unsecured
  • Specify treatment of each class of creditors
  • Provide for execution of reorganization

  § BFP v. Resolution Trust Corp. → 11 USC 548(a)(2)(A) permits avoidance of fraudulent transfers by insolvent debtor if foreclosure sale is of “reasonably equivalent value”?
    • Durrett says it means FMV – but how is that determined in foreclosure proceeding b/c the foreclosure sale is a forced sale?
    • Holding = If sale follows procedures of state foreclosure statute, then proceeds from the sale constitute “reasonably equivalent value."
      o Foreclosure law = State property law; “reasonably equivalent value” does not pre-empt state law
    • If foreclosure sale is not of “reasonably equivalent value,” then the property is available to all of the other creditors. If it is “reasonably equivalent” then only one creditor benefits – the one that foreclosed

  § Cram-down = Court can approve a Reorganization Plan even if 1 or more of the classes dissent
    o Chapter 12 = farm bankruptcy – helping people keep the family farm
    o Chapter 13 = Small business reorganization

Environmental Regulations
- CERCLA – 10 pages of definitions
  o 20(A) = owner or operator = “does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.”
    ▪ **Lenders could be viewed as owners** under this definition
  o 35 = Innocent landowner defense → contractual relationship exceptions including:
    ▪ Acquisition of property after hazardous substance has been disposed or placed on land if defendant did not know and had no reason to know
that any hazardous substance was released on the property is not a contractual relationship

- **Strict Liability** – cost of clean-up allocated to other parties
  - Defenses – 9607(b)
    - Act of God
    - Act of war
    - Innocent landowner
  - 9607(e) = **Indemnification – Hold Harmless Agreement**
    - Not effective against government, but effective against individual parties

- Tools for the real estate lawyer to deal with environmental contamination
  - **Technical**
    - Phase I Environmental Assessment = Non-intrusive study of the site
      - To think about as a lawyer
        - Access
        - Confidentiality
        - Liability – torts, etc.
    - Cleanup and Sell = good for simple sites
  - **Legal**
    - Indemnity – if anything happens, I’ll be liable and you won’t be
      - Requires security
    - Bridge owner (usually public) → City becomes first owner to protect against liability
      - Brownfields give-away program is easier to get for a city than a developer – more money becomes available
  - **Governmental**
    - Prospective Purchaser Agreement = government will promise to never sue a developer for cleanup costs
    - Comfort Letters = not a covenant not to sue, but the government doesn’t care about this site
    - Voluntary Clean-Up Program
      - No Further Action Letter = Government requires no further action on the site
  - **Financial**
    - **Prediction Insurance** – policy based on predicting fate and transport of an existing risk
      - Prediction based on end use – predict clean up cost consistent with the end use
      - Cost cap coverage
      - Escrow – 30M in escrow by developer based on predicted cost of cleanup, 3M environmental team pays this if their’s trouble, 60M paid by insurance co. = 93M protection of sellers
      - Incentives = more important than documents

- Things to be aware about environmental law:
  - Reporting – to whom do we report contamination? Must we report all contamination?
- Virtually **nothing must be reported to the government** for purposes of real estate development
- Reporting laws are narrow
- Spills must be reported
  - Cleanup – no legal obligation to clean up contamination; finding contamination does not create a duty to cleanup the contamination
    - Proactive Environmental Law = you have to do something
    - Reactive Environmental Law = you may have to do something some day if the government decides to do something about it – otherwise you can just wait them out
      - Superfund = reactive
  - It’s all about numbers – cleanness is not determined by how many parts per billion exist under the ground
    - It’s actually about risk – must be a route of exposure
      - Solution = design structure to reduce risk of exposure