ACREL News

President's Message

The College conducted a spectacular Mid-Year Meeting in Las Vegas March 8-11 thanks to the Meetings and Programs Committees and the efforts of Jill and Henri. As terrific as their efforts were, I don't believe they changed the luck of most of the Fellows at the tables in the adjacent casino. Ah, well! Meeting highlights included a very interesting Saturday morning program and small group discussions focused on strategies to profit from recent changes in the real estate and legal industries, an excellent Habitat for Humanity work project on Saturday afternoon, and a performance by professional dancers at the Saturday night dinner dance, followed by dancing lessons for the brave or the talented.

The Board approved three proposed Bylaws changes for presentation to Fellows at the Annual meeting October 18-21 in Chicago. The main Bylaw change for approval proposes the creation of an Audit Committee to advise the Board on financial and accounting practices. If you have accounting or audit knowledge or experience, please contact me at ann.saegert@haynesboone.com so we can appoint our most knowledgeable Fellows to serve on our new audit committee.

Our substantive committees have been extremely active this year. Substantive programs are planned during committee calls between ACREL meetings, and there are more committee projects, more substantive discussions and presentations occurring at our committee meetings at the Mid-Year and Fall Meetings, and our committees are welcoming and engaging our newer Fellows into committee activities. The ACREL substantive committees are listed on pages 40-43 of the 2012 ACREL Directory. Membership on these committees is open to everyone. To join a substantive committee, please let Jill, Henri, the Chair of your chosen substantive committee(s) or me know of your interest. You will be placed on the committee membership roster immediately. The name of the Chair of each substantive committee is also listed on pages 40-43 of the ACREL Directory.

If you have ideas to share for programs for upcoming meetings or suggestions for ACREL webinars or webinars produced jointly with ALI ABA or the MBA, please contact Peggy Rolando or Larry Shulman, Co-Chairs of our Programs Committee this year. Planning for the

continued on page 2

IN THIS ISSUE

President's Message

continued from page 1

Plenary Sessions (formerly known as the "Main Programs") for the Chicago (October, 2012) and Naples (March, 2013) meetings is completed, but your ideas for Roundtables (formerly known as "Workshops") at those meetings, for our 2013 and 2014 Vancouver, Kauai or Boston programs or subsequent meetings or webinars will be most appreciated.

Mark your calendar today for our 2012 Annual Meeting at the Renaissance Hotel in Chicago on October 18-21, 2012. You can also find a list of all the webinars available to all of our ACREL Fellows by clicking the following link http://www.acrel.org/DrawOnePage.aspx?PageID=62. If you are interested in hosting a local ACREL meeting in your City, but just need some help with the planning, please contact Jill, Henri or me for ideas and suggestions.

See you in Chicago in October!

Ann

Ann M. Saegert, President

STAFF BOX

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Frederick S. Lane Award

The Frederick S. Lane Award is ACREL's highest honor, bestowed from time to time by the Board of Governors in recognition of exceptional service by a Fellow to the public, the profession and the College. Established in 1993 in honor of Frederick S. Lane, one of the founders of the College and its first President, the Lane Award has been given to the following Fellows to date: Fred Lane (1993), John Gose (1996), Tony Kuklin (1996), Ed Hirschler (1998), John Hastie (2002), Bob Hetlage (2003) and Don Siskind (2004).

While because of the unique nature of the award there is no expectation that a recipient will be identified every year, the Board of Governors has appointed a Lane Award Advisory Committee, currently chaired by Mark Mehlman, to evaluate any proposed recipients and make nominations as the Committee deems appropriate for the Board's consideration. As with our past recipients, nominees should be highly respected members of the College who would be immediately recognized as selfless mentors and role models with significant contributions to ACREL, the profession, and the public spanning several decades. While it is expected that a nominee will have demonstrated significant leadership and influence within ACREL, he or she need not have been an ACREL officer.

If you would like to propose a Fellow for consideration whom you believe meets the standard of exceptional service which the Award represents, the Committee invites you to do so by submitting the name to Mark Mehlman at mark.mehlman@snrdenton.com. The Committee will maintain the utmost confidentiality in its consideration of any proposed recipients, and requests that proposers do the same. Names must be received not later than July 1, 2012 to be considered for possible award at the ACREL Mid-Year Meeting in 2013. ■

New York Court Dismisses Lawsuit Against Law Firm that Rendered Opinion Letter in Fraudulent Transaction

*by Edward J. Levin**

In the Summer of 2010 the legal opinion world was rocked by news that the claim of affiliates of Fortress Investment Group against the law firm Dechert LLP for $50 million in damages arising from a legal opinion letter that Dechert gave had survived a motion to dismiss. That world has settled down somewhat on the news that on November 29, 2011 a New York intermediate appellate court (the State of New York Supreme Court, Appellate Division, First Department), dismissed Fortress's claims against Dechert. *Fortress Credit Corp. v. Dechert LLP*, 89 A.D. 3d 615, 934 N.Y.S. 2d 119 (2011).

Dechert issued a legal opinion letter to Fortress, the lender, in a fraudulent financing that was arranged by Marc S. Dreier. Dreier, who was then an attorney and had represented the purported borrowers (Solow Realty & Development Company, LLC and affiliates) on litigation matters for a number of years, forged the signatures of the borrowers on the loan documents and other documents, and he misappropriated the loan proceeds after they were wired to his trust account. In May, 2009 Dreier pleaded guilty in federal court to orchestrating a massive Ponzi scheme and to conspiracy to commit securities fraud and wire fraud, money laundering, securities fraud, and wire fraud. He was sentenced to 20 years in prison and disbarred.

According to court pleadings, starting in 2005, ostensibly on behalf of the borrowers, Dreier arranged with the lender to borrow money to finance the purchase of foreign real estate assets. Dreier acted as a limited guarantor and manager of the loans. The initial loan of $25 million closed in January 2006, and it was extended and increased in 2007 to approximately $50 million. In 2008, the lender agreed to make an additional loan of $50 million to the borrowers, but the lender insisted that the borrowers hire an independent law firm to issue an opinion letter to the lender. Dreier engaged Dechert to serve in that role and paid it $100,000.

The lender made the additional loan of $50 million to the borrowers, but the borrowers had no knowledge of the loan, did not authorize it, did not sign the loan documents, and never received the loan proceeds. Dechert, the law firm that was supposedly representing the borrowers, had no direct contact with the borrowers or any of their officers or employees. Dechert's only contact regarding the borrowers was with Dreier. Dechert undertook no due diligence to determine the involvement, or lack of involvement, of the borrowers in the loan transaction.

In connection with the additional $50 million loan, on June 25, 2008, Dechert, as

* Edward J. Levin is a member of Gordon Feinblatt LLC in Baltimore, Maryland. He is Chair of the Legal Opinions in Real Estate Transactions Committee of the Section of Real Property, Trust and Estate Law of the American Bar Association and Chair of the Special Joint Committee on Lawyers' Opinions in Business Transactions of the Maryland State Bar Association's Section of Business Law and the Section of Real Property, Planning and Zoning. He is past chair of the America College of Real Estate Lawyers Attorneys' Opinions Committee. The opinions expressed in this article are those of the author and not of the committees. The author wishes to thank Cheri Wyron Levin, Esquire for her advice and editorial suggestions on this article.

continued on page 4

continued from page 3

"special corporate counsel" to the borrowers and Dreier (collectively, the "Loan Parties"), rendered an enforceability opinion in favor of the lender. That opinion provided "each of the Transaction Documents constitutes the valid and binding obligation of each of the Loan Parties . . . enforceable against such Loan Party in accordance with its terms." Dechert also included in its letter the opinion that "each of the Loan Parties has duly executed and delivered each of the Transaction Documents to which it is a party." With those opinions in hand, the lender funded the $50 million loan.

In New York "Near Privity" Is Sufficient

If a lender wants to collect damages for harm caused by a third-party opinion letter written in connection with a loan, it must first find one or more viable causes of action that it can pursue against the law firm that gave the opinion. Because the opinion issuer represents the borrower (and perhaps other loan parties, such as guarantors) and delivers the opinion letter on their behalf to the lender, the lender is not the client of the law firm that renders the opinion. In other words, the lender is a "nonclient" as to the law firm. The *Fortress* Court found that there could not be an action for legal malpractice by the lender against Dechert because they did not have an attorney-client relationship.

Also, as a general matter, the opinion giver does not have a contract with the lender, and so there is no legal "privity"[1] between them. In 1879, the United States Supreme Court required that there be privity for a nonclient to recover against a lawyer who issued a faulty opinion of title.[2] However, New York courts have fashioned an exception to this rule.

The *Fortress* Court cited *Prudential Insurance Company of America v. Dewey, Ballantine, Bushby, Palmer & Wood*, 80 N.Y.S.2d 377, 605 N.E.2d 318, 590 N.Y.S.2d 831 (1992), for the proposition that in New York, to permit recovery for pecuniary loss sustained as a result of another's negligent misrepresentations, there must be a showing that there was either actual privity of contract between the parties or a relationship "so close as to approach that of privity," sometimes referred to as "near privity."[3] In satisfaction of this requirement, the Court in the *Fortress* case found that the lender's Complaint alleged a "near privity" relationship because it averred that the purpose of the opinion letter was to aid the lender in deciding whether to enter into the loan, Dechert was aware that the lender was relying on the opinion in determining whether to make the loan, and Dechert showed its understanding of this reliance by addressing the opinion letter to the lender. Stated differently, under New York law, a law firm that represents a borrower may have liability to a lender in connection with an opinion letter issued in a loan transaction.

Law Firm Not Liable Based On The Facts Alleged In The Complaint

Although the *Fortress* Court held that the lender could sue Dechert because it found "near privity," the Court declined to hold Dechert liable for damages to the lender in that case. The Court noted that because the

1 Privity of contract is defined as "the relationship between the parties to a contract, allowing them to sue each other but preventing a third party from doing so." *Black's Law Dictionary* 1199 (9th ed., West 2009).

2 *Savings Bank v. Ward*, 100 U.S. 195, 25 L.Ed 621 (1879).

3 *Prudential* involved a law firm that issued an opinion that mortgage loan documents were enforceable "in accordance with [their] respective terms" even though the mortgage inadvertently left out three zeros from the amount secured.

continued on page 5

Complaint did not allege that the lender advised Dechert that its obligations were not limited to the review of only specified documents and the Complaint did not allege that the lender advised Dechert that it needed to investigate, verify, and report on the legitimacy of the loan transaction, the lender could not establish that Dechert breached a duty of care. The Court also found that Dechert had no reason to suspect that the borrowers were not actually participants in the loan transaction or that their signatures had been forged.

The Court in *Fortress* found that Dechert's statements in the opinion letter were not misrepresentations, as would be required to find liability under the *Prudential* case, because the opinion letter stated that Dechert had not made an independent inquiry into the accuracy of the factual representations or certificates.

The *Fortress* Court also rejected the claim that Dechert was liable for fraud. The Complaint alleged that Dechert acted recklessly for failing to confirm that the borrowers were actually involved in the loan, but the Court held that this was not a sufficient allegation of scienter (guilty knowledge), which is a necessary element in an action for fraud. The Court based this holding on its findings that there were no allegations that Dechert made a knowingly false statement or that it knowingly participated in the fraud.

Explicit Assumptions Enable The Law Firm To Escape Liability

Significantly, Dechert included in its opinion letter an assumption that the signatures on all of the documents were genuine and an assumption that all of the documents it had seen were authentic. The *Fortress* Court said that the opinion letter "was clearly and unequivocally circumscribed by the[se] qualifications." Essentially, these assumptions had the effect of enabling Dechert to issue the opinion letter as if the certificates of the borrowers, the resolutions of the borrowers, and the loan documents were authorized by the borrowers and that they were properly signed and delivered by them. As it turned out, all of these documents were forged by Dreier, but the Court allowed the opinion to be read as if all of the documents were approved and signed by the borrowers. Therefore, the Court held that the lender's Complaint failed to state a cause of action against Dechert for breach of fiduciary duty. Accordingly, the *Fortress* Court reversed the decision of the trial court and ordered that the case against Dechert be dismissed.

Notwithstanding the law firm's role in the fraud perpetrated by Marc Dreier, Dechert has avoided liability to the lender for now. Dechert allegedly did no due diligence before issuing its letter, did not even meet with, correspond with, or otherwise communicate with its "clients," and rendered its opinion letter based on forged entity certificates, entity resolutions, and loan documents. It can be inferred from the fact that that Dechert received a fee of $100,000 for only a few days' work that it should have known that something was amiss. Despite this, the *Fortress* Court read the assumptions that Dechert included in its opinion letter literally and interpreted the letter in the fictional world that the opinion letter described.

Courts Have Moved Away From Requiring Privity As A Basis For A Lawyer's Liability To A Nonclient

Courts in different states have established bases for finding possible liability for a lawyer to a nonclient in certain instances, under theories other than the "near privity" concept set forth in the *Fortress* and *Prudential* cases.

continued on page 6

In a number of states a lawyer may be found liable under the third party beneficiary rule. For example, the Maryland Court of Appeals held in *Flaherty v. Weinberg*, 303 Md. 116, 121-23 (1985), "To establish a duty owed by the attorney to the nonclient the latter must allege and prove that the intent of the client to benefit the nonclient was a direct purpose of the transaction or relationship."

The court in *Greycas, Inc. v. Proud*, 826 F.2d 1560 (7th Cir. 1987), carefully examined the tort of negligent misrepresentation in a case in which an attorney reported that he conducted title and judgment searches when he did not. The *Greycas* court observed that the Illinois Supreme Court had earlier discarded the common law requirement of privity for professional malpractice but required that for a nonclient to succeed in a negligence action against an attorney, it must prove that the primary purpose and intent of the attorney-client relationship itself was to benefit or influence the third party.[4]

In *Petrillo v. Bachenberg*, 139 N.J. 472, 655 A.2d 1354 (1995), the New Jersey Supreme Court found a lawyer for the seller of property liable to the buyer, a nonclient, for providing a composite report of some but not all percolation tests performed on the property that was the subject of the transaction between the parties. In reaching its holding, the New Jersey Court reviewed circumstances in which courts had relaxed the privity requirement by limiting a lawyer's duty to third persons to situations in which the lawyer intended or should have foreseen that the third party would rely on the lawyer's work.

The Colorado Supreme Court in *Mehaffy, Rider, Windholz & Wilson v. Central Bank of Denver, N.A.*, 892 P.2d 230 (1995), demonstrated a willingness to find an attorney who issued a misleading opinion letter liable to a recipient nonclient based upon negligent misrepresentation. This, according to the Colorado Supreme Court, requires knowledge by the provider that the information will be relied on by the nonclient.

In addition, there are cases that do not purport to create <u>exceptions</u> to privity, but rather focus on policy reasons as to why privity should not matter.

In *Biakanja v. Irving*, 49 Cal.2d 647, 320 P.2d 16 (1958), regarded as a landmark <u>departure</u> from the rule of privity, the Supreme Court of California noted prior cases in which privity did not stand in the way of a finding of liability: where the negligence places life and limb in peril; where the only foreseeable risk is of damage to tangible property; or where the "end and aim" of the transaction was the third person's interests. In the *Biakanja* case, the plaintiff was a frustrated beneficiary under an improperly executed will prepared by the defendant, a notary public. In imposing liability on the negligent notary in favor of the beneficiary, the court provided six factors that were to be balanced in determining whether a defendant in a specific case would be held liable to a third person not in privity. These were: (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to the plaintiff; (3) the degree of certainty that the plaintiff suffered injury; (4) the closeness of the connection between the defendant's conduct and the injury suffered; (5) the moral blame attached to the defendant's conduct; and (6) the policy of preventing future harm.[5]

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4 *Pelham v. Griesheimer*, 440 N.E.2d 96, 100 (Ill. 1982).

5 *Biakanja*, at 650, 320 P.2d at 19. The six factors have been referred to in many cases as the "*Biakanja* balancing tests."

continued on page 7

The label "third party beneficiary" was subsequently attached to the *Biakanja* principle in *Lucas v. Hamm*, 56 Cal.2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), which took the ultimate step of applying the rationale of *Biakanja* to an attorney. In its decision, the California Supreme Court addressed the question of whether recognition of liability to beneficiaries under a will negligently drawn by an attorney would impose an undue burden on the profession. The court concluded that extension of the attorney's liability to beneficiaries injured by a poorly drafted will does not place an undue burden on lawyers generally.[6]

In *Donahue v. Shughart, Thomson & Kilroy, P.C.*, 900 S.W.2d 624 (Mo. Banc 1995), the Missouri Supreme Court extended liability to an attorney who had negligently prepared an *inter vivos* trust. The *Donahue* court slightly modified the six balancing factors of *Biakanja*, but the court focused on the test of the client's purpose and specific intent to benefit the nonclient claimant through the attorney-client relationship.

At this time there seems to be little doubt that a third party addressee of an opinion in a business transaction will be able to recover against the opinion giver if the addressee can establish that it reasonably relied on the opinion, that it suffered a loss proximately caused thereby, and that the opinion giver was negligent. *See* 2007 Report on Lawyers' Opinions in Business Transactions by the Special Joint Committee of the Section of Business Law and the Section of Real Property, Planning and Zoning of the Maryland State Bar Association, Inc., revised as of October 6, 2009, found at http://msba.org/docs/opinionmatters.asp (the "Maryland Opinion Report") at page 24.

Execution And Delivery Opinions May Be Part Of Enforceability Opinions

In order for loan documents to be enforceable, among other things, they must be executed and delivered by the proper persons. Therefore, if an enforceability opinion is given, an execution and delivery opinion is implicitly a component of it. *See* §10.4 of the Third-Party Legal Opinion Report, including the Legal Opinion Accord (the "Accord") 47 BUS. LAW. 167 (1991) and 29 REAL PROP. PROB. & TR. J. 487 (1994) and Section D.4, page 53 of the Maryland Opinion Report.

However, in third-party opinion letter practice throughout the United States, as a matter of form the execution and delivery opinion is generally stated separately from the enforceability opinion.[7] As examples, *see* the Inclusive Real Estate Secured Transaction Opinion[8] and illustrative opinion letters that are parts of the opinion reports issued in Arizona, Florida, Maryland, North Carolina, Pennsylvania, and Washington.

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6 The attorney was not found liable because the alleged negligence involved did not violate the standard of care required of a lawyer. The trust created under the instrument was invalid because it violated the rule against perpetuities -- a rule deemed perplexing and difficult for most members of the bar. *Lucas*, at 592, 364 P.2d at 690.

7 As a departure from this rule, the illustrative opinion letter that is part of the Accord does not state the execution and delivery opinion separately.

8 Inclusive Real Estate Secured Transaction Opinion, In Which are Incorporated the Principal Concepts of the ABA Section of Business Law Legal Opinion Accord and the ABA Section of Real Property, Probate and Trust Law and the American College of Real Estate Lawyers Report on Adaptation of the Legal Opinion Accord, Published in 1998 at http://www.acrel.org/Documents/PublicDocuments/InclusiveRealEstateSecuredTransactionOpinion.htm and http://apps.americanbar.org/dch/committee.cfm?com=RP213000.

continued on page 8

Execution And Delivery May Be Assumed In Opinion Letters

A number of sources state that an assumption regarding the genuineness of signatures is implicit in all closing opinions.[9] In order to make this position clear, many opinion givers explicitly assume that "all signatures are genuine."

However, many opinion letters do not contain the assumption that "all signatures are genuine," but instead include the assumption that "all signatures <u>other than the borrower's</u> are genuine" – carving the borrower's signature out of the assumption. The latter assumption is often found in forms prepared by or for recipients of opinion letters. If an opinion giver uses the latter version of this assumption, the opinion giver would be vouching for the signatures of its own client (the borrower). Regarding this, the Maryland Opinion Report states, "In the view of the Committee, such an assurance is not an opinion of law but the guarantee of a fact that may be outside of the knowledge of the opinion giver. The Committee believes that such a request is inappropriate in most instances and that the language [that is underlined above] should be omitted." *Id* at page 176.

What if there is both an <u>assumption</u> that the documents have been executed and delivered and an <u>opinion</u> that the documents have been executed and delivered? By including an explicit assumption, the opinion giver would say that its intention is that the assumption should control. However, the presence of the freestanding opinion that is in the same form as the assumption provides an opinion recipient, and perhaps a court, the opportunity to read the opinion and ignore the assumption – with potentially dangerous consequences for the opinion giver.

How An Opinion Letter May Be Read As Having Execution And Delivery Assumptions

If an opinion giver is going to render an enforceability opinion and does not want to vouch for the signatures of its clients, it may do so in several ways. It can omit a separate opinion stating that the documents have been executed and delivered by the borrower, but because an enforceability opinion encompasses an execution and delivery opinion, this is not sufficient by itself. The most direct way is for the opinion letter to include an assumption that the clients have executed and delivered the documents, and to not include an execution and delivery opinion.

Without an assumption that the clients have executed and delivered the documents, the opinion letter can explicitly include assumptions that all documents submitted to the opinion giver are authentic and that all signatures on the transaction documents are genuine. Dechert included such explicit assumptions in its opinion letter, and the Court in *Fortress* placed a great deal of weight on them when it dismissed the Complaint against Dechert.

Alternatively, if a lawyer issuing an opinion letter practices in a jurisdiction that has published an opinion report that provides that

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9 *See* Accord §4(e); §III.D of the *Legal Opinion Principles* by the Committee on Legal Opinions of the Section of Business Law of the American Bar Association published at 53 Bus. Law. 831 (1998); Donald W. Glazer, Scott FitzGibbon and Steven O. Weise, Glazer & FitzGibbon, *Glazer & FitzGibbon on Legal Opinions* (3rd ed. 2008, 2010 cum. supp), §9.4, page 287; *Report of the TriBar Opinion Committee: Third-Party Closing Opinions,* 53 Bus. Law. 591 (1998) (the "TriBar 1998 Report") at 654 n. 147; 2005 Report on Legal opinions in Business Transactions, Corporations Committee of the Business Law Section of The State Bar of California, §V.B. 2.b; and Maryland Opinion Report, §D.4 at page 53.

continued on page 9

continued from page 8

assumptions that all documents are authentic and all signatures are genuine are implicit, that lawyer may include these assumptions by reference to the applicable opinion report. Therefore, in such a situation, the assumptions regarding genuineness of all signatures and authenticity of documents would be deemed part of the opinion letter, even if they are not explicitly stated in the opinion letter.

On the other hand, if an opinion letter includes the assumption that "all signatures <u>other than the borrower's</u> are genuine," and the letter includes an enforceability opinion (whether or not it includes a separate execution and delivery opinion as well), the opinion giver would be providing assurance to the lender that the signatures of the borrower on the documents are not forgeries.

Conclusion

There are lessons to be learned from the *Fortress* case. First, even if a law firm that gives an enforceability opinion in a loan transaction includes explicit assumptions about the authenticity of documents and the genuineness of signatures, it is prudent to check with the borrower directly to confirm that it has signed the papers.

The second lesson is not from the outcome of the *Fortress* case, but it emerges from an analysis of the decision. It is this: it is not good practice to include in an opinion letter an opinion that has been assumed away and thus is intended by the opinion giver to have no meaning. A court may not come to that conclusion. *See* Accord §4(e)

An example is an opinion letter that has a freestanding execution and delivery opinion as well as assumptions on authenticity of documents and genuineness of signatures (as the Dechert letter did). The opinion giver will contend that the assumptions are significant and that the execution and delivery opinion adds nothing to the assumptions. However, a court may instead decide that at least some purpose should be given to every single opinion in an opinion letter and that the execution and delivery opinion contains some substantive assurance and reflects an independent evaluation by the opinion giver.

Dechert may have avoided liability for now, but the *Fortress* case may not be over yet. Fortress has filed a motion for leave to appeal the intermediate appellant court's decision. ■

INSURANCE REDUX: Reprise and Update on the Protective Safeguards Endorsement

Authors' Note: In the discussions at the Insurance Roundtable held at the ACREL Mid-Year Meeting in Las Vegas, there was mention of the Protective Safeguards Endorsement which is a quite common, and equally quite unnoticed, endorsement to standard commercial property insurance policies . . . but which creates potentially catastrophic exposures to property owners. Below is a reprint of an article that appeared in the *ACREL News* December 2008 (Vol. 26 No. 4) and a more recent memo commenting on practical aspects of obtaining property insurance coverage without the endorsement.

I. Insurance: What You Don't Know Can Definitely Hurt You!

by David S. Gordon, Wilentz, Goldman & Spitzer, P.A., Woodbridge, NJ, December 2008

We have all reviewed leases in which the tenant is prohibited from doing anything that would increase the premiums for the landlord's insurance. I recently reviewed a lease that provided the tenant would not do anything that would void the landlord's insurance, increase the insurance risk or "cause the disallowance of any sprinkler credits." The concept of sprinkler credits was new to me. I assumed (silly me!) that it was an issue of cost, related to something special in insurance premium underwriting. I asked a knowledgeable insurance consultant about the language and was surprised by his response.

Charles "Cappy" Stults (cstults@allen-stults.com) of Allen & Stults Co. in Hightstown, NJ, responded as follows:

> "It is worse than just a premium underwriting issue. Most (if not all) policies that get sprinkler credits have a 'Protective Safeguards Endorsement,' which means that the sprinkler system must be maintained and not changed or compromised; and if it is, the [fire insurance] coverage would not apply. So in this case it is worse than a higher premium, because it results in no coverage.
>
> Regarding the wording you refer to, sprinklers are designed for different hazards. Space leased to an office tenant may not have as many heads or the same types of heads as would space leased to a restaurant tenant. If the lease was for office space and the tenant sublet or started a side business of shipping paper goods and stored them in one area, this would increase the 'hazard' and, when inspected, would result in elimination of the sprinkler credits. Adding a wall within a space could also change sprinkler credits."

The specific language of the Protective Safeguards Endorsement (ISO form IL 04 15 04 98) provides that the carrier will not pay for loss or damage by fire if the insured "**. . .** knew of any suspension or impairment in any protective

continued on page 11

continued from page 10

safeguard listed in the Schedule **. . .** and failed to notify [the insurer] of that fact; or **. . .** failed to maintain any protective safeguard listed in the Schedule **. . .** , and over which [the insured] had control, in complete working order." The safeguards include an automatic sprinkler system, an automatic fire-alarm system, a security service with recording or watch clocks making hourly inspections of the entire premises when not in operation, a private fire department contract, and other items that can be specifically listed in the schedule of the endorsement.

While this answer would not materially affect my response to the proposed lease language noted above, it provides a good reason why a landlord's lease form should both specify the particular use which the tenant will make of the premises and allow absolutely no alterations to the premises without the landlord's approval, and why tenant's counsel might be well advised not to object too strongly to such provisions. Additionally, landlords (and their attorneys) should have alteration plans reviewed not only by engineers, but by insurance professionals as well, so that the insurance professional can determine if the carrier needs notice of the alterations. The relatively common exception allowing a tenant to make non-structural interior alterations, which do not affect building systems and do not cost in excess of a stated amount, could easily result in a loss of the landlord's fire-insurance coverage. After an uninsured loss it would be of little solace (to the landlord or to the tenant) to find that the tenant was in fact required to obtain prior approval of the plans because they "affected" the building's sprinkler system but did not on the assumption that they were non-structural and below the cost threshold. And woe to the poor tenant's attorney who is asked by the tenant to look at the lease and comes to the same conclusion. Similarly, an "any lawful use" clause that allows a tenant to change uses without notice to the landlord could expose the landlord to a loss of fire insurance proceeds if the lawful use was to a use group with sprinkler specifications more stringent than those in existence at the premises.

Practice Tip: If your client has a sprinkler leak and needs to shut down the system temporarily for repairs, be sure to advise the carrier and to confirm the suspension of the Protective Safeguards Endorsement. Similarly, should a malfunction (electrical surge or lightning strike) disable the fire alarm system, prompt notice should be provided to the carrier. Perhaps in both cases, notice to the municipality also might be in order, because operation of the facility without an important life-safety system could be a violation of building codes. In either case, an agreement to use a fire watch security service as a temporary measure might be acceptable as a way to keep operations from being interrupted.

Another Practice Tip: Check your malpractice insurance policy. If you represent the landlord, who is unable to collect on its fire insurance because the alteration provisions in the lease were improperly drafted and the tenant's fire legal liability coverage is woefully insufficient, the parties will be grasping at straws and your malpractice insurance policy may just look like an island oasis in a stormy sea.

(Memorandum is on next page)

continued on page 12

continued from page 11

II. MEMORANDUM

TO: **David Gordon**

FROM: **Arthur E. Pape**

DATE: **March 27, 2012**

RE: **Further to the Roundtable - Protective Safeguards Endorsement**

As you know I was astounded by the discussion of the Protective Safeguards Endorsement. I looked it up in my IRMI[1] Binder. IRMI says that:

> "If possible, it is best to avoid this endorsement. However, ISO[2] CLM Division 5 Rule 12 makes its use mandatory whenever a protective safeguards symbol is included in the published rate for a specific building. If the protective safeguards endorsement is attached to the policy, the insured and the agent or broker will have to be scrupulously careful to notify the insurer immediately of even the slightest, shortest impairment, and to document the notification in writing."
> *International Risk Management Institute, Inc. Commercial Property Insurance, VI.O.4*

I also talked to my guru, Sandra McClive of Hylant Group, about the ability to have the policy issued without this Endorsement. She gave me three instances:

1. It is a large enough risk with large enough premiums that it will be removed almost as a matter of course.

2. Occasionally, where it is a single-tenant building and the owner argues that although it maintains the insurance, the tenant is in total control.

3. Where the building is insured as a non sprinklered, non security system building, which would add about 10% to the premium but is sometimes worth it.

Sandra advised that insurers will not buy argument #2 above in a multi-tenant building because theoretically there is a property manager. The Protective Safeguards Endorsement can be a real risk of which I was totally unaware. I will bet there are a lot of insureds (and insurance agents) who are not aware of the risk they are leaving open. ■

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1 International Risk Management Institute, Inc. *See*, www.IRMI.com.
2 ISO (Insurance Service Office) is an industry association that promulgates policy and endorsement forms and procedures.

Enforceability of Carveouts to Nonrecourse Loans: Recent Cases*

by John C. Murray, First American Title Insurance Company ©2012

Introduction

Since the mid-1980s, lenders have been qualifying and restricting nonrecourse provisions in commercial real-estate loans by making exceptions for certain acts by borrowers that are deemed to be within the borrower's control. In recent years, many lenders have expanded the scope of such "carveouts" to include risks of exposure to the property's economic deterioration or neglect. Some nonrecourse provisions provide that the borrower is liable for the specific damages resulting from the violation or breach of a carveout, while others state that the entire loan becomes recourse to the borrower if any of (or certain of) the excepted acts occurs. In some cases the exceptions have virtually swallowed the rule; i.e., the clause is drafted so that the borrower has personal liability for virtually all defaults under the loan documents except the failure to pay the principal and interest due on the loan (and, under the most recent case law discussed below, even the failure to pay principal and interest alone may trigger total recourse liability under certain circumstances if the language in the nonrecourse and carveout provisions is so drafted and interpreted). There has been relatively little case law regarding the validity and enforceability of such carveouts, as these provisions have rarely been challenged by borrowers or guarantors. But in the current severely depressed commercial real estate market, with the commensurate increase in mortgage loan defaults (especially with respect to commercial mortgage-backed securities ("CMBS") loans, where the isolation, preservation and continuation of the income stream from the mortgaged property are especially important), more federal and state court actions challenging the validity and enforceability of carveout provisions are being brought by borrowers and guarantors (mostly without success). This article will discuss and analyze the most recent court decisions in this area.

Background

True nonrecourse loans are rare today. Commercial real estate values have substantially declined. In the past (and even currently, to a lesser extent) much real estate value was created by investors seeking tax or related benefits who were not particularly concerned about adding to – or in some cases even maintaining – the value of the property, or by foreign investors seeking unique opportunities or higher returns (however modest) than were available in their own countries. Many lenders began to realize – especially after being "burned" in bankruptcy proceedings filed by or against their borrowers – that standard nonrecourse mortgage provisions in some cases actually encouraged borrowers to contest lender enforcement actions and to file bankruptcy proceedings, as borrowers had no risk of personal liability and could delay or even avoid unfavorable tax consequences. Lenders learned that, because of the absence of personal risk to borrowers and the lack of a direct monetary incentive for borrowers to properly operate and maintain the property, their security could suffer

* Nothing contained in this Article is to be considered as the rendering of legal advice for specific matters, and readers are responsible for obtaining such advice from their own legal counsel. This Article is intended for educational and informational purposes only. The views and opinions expressed in this Article are solely those of the Author, and do not necessarily reflect the views, opinions, or policies of the Author's employer, First American Title Insurance Company.

continued on page 14

continued from page 13

a substantial loss in the value that was originally determined as the basis for underwriting the loan.

The carveout exceptions to nonrecourse mortgage provisions have evolved from traditional borrower acts such as fraud, material misrepresentation, and the diversion of the loan proceeds, to include matters of conduct (or inaction or misconduct) related to the economic performance of the property, such as the misapplication of rental income, environmental contamination of the property, and physical or economic waste of the property. The exceptions to nonrecourse have expanded to include obligations to properly maintain the property and preserve its value.

Certain carveouts relating to the lender's efforts to protect itself from a loss of the property's value, or the diversion, misappropriation, or misapplication of the property's income stream, may be more amenable to a limited quantifiable-damages remedy. The following are examples of these types of covenants: the failure to properly apply insurance or condemnation proceeds to the restoration or repair of the property and the improvements thereon; the diversion or misapplication of security deposits and unpaid rents; the misapplication or diversion of rental income after a loan default; the failure of the borrower to perform its obligations as landlord under leases in effect on the property; physical neglect or waste of the property; "economic waste" of the property (such as the failure to pay property taxes and assessments); failure to discharge mechanic's liens and other monetary encumbrances and judgment liens against the property; failure to insure the property or pay the insurance premiums when due; failure to comply with applicable laws and regulations affecting the property; failure to maintain the property in a "suitable condition" to prevent loss of value; and removing or "stripping" personal property essential to the use and operation of the property and the buildings and improvements thereon.

The lender must be realistic in the assessment of its ability to recover against the borrower if the borrower becomes personally liable as the result of the breach of a nonrecourse carveout. For example, the right to assert recourse liability against a single-purpose, bankruptcy-remote entity such as a limited liability company, business trust, thinly capitalized corporation, or a limited partnership with a single-member limited liability company as the general partner may be virtually worthless.

CMBS Loans – Current Cases

A. *The Chesterfield* Decision

In a recent case involving a nonrecourse securitized loan, *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., LLC*, 2011 WL 6153023 (E.D. Mich., Dec. 12, 2011), the plaintiff lender ("51382"), successor in interest to the original mortgage lender, Morgan Stanley Mortgage Capital Holdings, LLC, "Morgan Stanley") foreclosed its mortgage on the shopping-center property owned by the borrower ("Chesterfield") at a non-judicial Michigan foreclosure sale and purchased the property for an amount that was more than $12 million less than the outstanding balance of principal and interest due on the loan ("Debt"). Article 11 of the note contained an "exculpation" provision that made the Debt nonrecourse to Chesterfield and the guarantor (collectively, "Defendants"), except for certain designated "springing recourse obligations" that would make the Defendants fully liable for the Debt. (The guarantor, John Damico, signed a "Guaranty of Recourse Obligations of Borrower" at the time of execution of the

continued on page 15

continued from page 14

mortgage and other loan documents, which provided that the guarantor "absolutely and unconditionally guarantees to Lender the prompt and unconditional payment" of "all obligations and liabilities of Borrower for which Borrower shall be personally liable pursuant to Article 11 of the Note.")

51382 subsequently sued Defendants for the deficiency based on violation of one of the springing-recourse exceptions to nonrecourse, notably a provision in Section 4.2(j) of the mortgage that Chesterfield shall not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due and payable." The court ruled in favor of 51382, holding that Defendants were personally liable for the full amount of the remaining unpaid deficiency because "the Loan Agreement unambiguously provides that Defendants are liable for the deficiency balance." *Id*. at *3.

Defendants argued that they could not incur full recourse liability solely due to nonpayment of the Debt. But the court dismissed Defendants' argument, stating that "this dispute is merely one of semantics," *Id*. at *6 n.2, and that "the terms of the Loan Agreement unambiguously show that Plaintiff is correct." *Id*. at *7. The court found that notwithstanding the testimony offered with respect to the intention of Defendants and Morgan Stanley, there was no fraud, misrepresentation, or mutual mistake. The court stated that:

> At most, the evidence Defendants present shows that, though both they and Morgan Stanley intended to be bound by the terms of the Loan Agreement, both parties misunderstood the legal effect of the terms contained in that agreement.

Id. at *18.

The court ruled that there was no equitable reason to deny personal liability or reform the note, stating that:

> There are no equitable considerations in this case that urge the court to reform the Loan Agreement or otherwise relieve Defendants of their obligations under it, as Defendants are sophisticated parties who had the benefit of counsel when executing the Loan Agreement. Accordingly, the court will grant Plaintiff summary judgment on the Defendants' counterclaims for fraud and reformation.

Id.

The court further stated that "[e]xtrinsic evidence cannot be used to vary unambiguous contractual language" and "the court will hold those parties to their bargain." *Id*. at *15. Defendants argued that the court's ruling would cause the non-recourse exceptions to "swallow the rule" of the specific nonrecourse provision regarding payment of the Debt, making it meaningless. But the court rejected this argument, stating that "insolvency would not have resulted if the value of the property had been greater than the balance owing on the loan." *Id*. at *10. The court further stated that "the 'fail to pay' prong of Section 4.2(j) is broader than the 'insolvent' prong." *Id*. at *12. Thus, according to the court, "Chesterfield had an obligation to repay the loan in full, not an obligation to make payments on the Loan until doing so became financially undesirable and then await a foreclosure action." *Id*. at *13.

The court distinguished the "insolvency" exception to the nonrecourse language from the separate exception for a bankruptcy filing by or against Chesterfield, reasoning that

continued on page 16

continued from page 15

the specific bankruptcy exception involved a different interest of a lender than the insolvency exception, i.e., the bankruptcy exception "protects a lender's interest in the collateral and the loan by ensuring that a borrower remains a single-purpose, bankruptcy-remote entity." *Id.* at *10. The court noted that:

> Subsections (iv) through (vii) of Article 11(c) proscribe affirmative acts of a borrower that do not necessarily occur when a borrower becomes insolvent but that uniquely threaten a lender's ability to recover on the Loan. In light of the interests at stake, Lender was entitled to bargain for extra assurances that full recourse liability will result when the specific events of Article 11(c)(i), (iv), (v), (vi), and (vii) [contained in the note] occur. The fact that Lender ensured those provisions were contained in the Loan Agreement, along with the springing recourse obligation reflected in Article 11(c)(ii) [of the note] and Section 4.2(j) [of the mortgage], does not change the plain meaning of Section 4.2(j).

Id.

The court also rejected Defendants' argument that Chesterfield did not breach Section 4.2(j) of the mortgage because it used the assets it had available to pay its debts and liabilities. According to the court:

> Section 4.2(j) must require Chesterfield to pay its debts and liabilities *both* "from its assets *and* "as the same shall become due," otherwise one of these phrases is written out of the contract.

Id. at *13 (emphasis in text).

Unfortunately for Defendants, the court found that it was their own fault that the language regarding the nonrecourse carveouts (or "springing recourse events," as characterized by the court) was imprecisely negotiated and drafted. The court stated that:

> Before executing the Loan Agreement, Chesterfield was free to negotiate terms favorable to its interests or acquiesce to terms favorable to Morgan Stanley's interests, but it cannot take the latter course and then void the agreement when that decision produces unfavorable consequences. Plaintiffs [*sic*] acknowledge that the springing recourse events contained in the Loan Agreement are extremely, even unusually, favorable to Lender: the "fail to pay" prong of Section 4.2(j) is not ubiquitous to CMBS contracts.

Id. at *16.

Thus the court concluded that "Defendants' buyer's remorse occasioned by Plaintiff's efforts to exercise the rights accorded them by the Loan Agreement is not cause for voiding the contract." *Id*.

Finally, Defendants devoted the majority of their briefing and oral argument to their belief that, on public-policy grounds, the court's decision "does violence to the very nature of commercial mortgage-backed security loans ('CMBS' loans), and the court's enforcement of those provisions as written will have disastrous consequences in the real estate market." *Id*. at *15. Defendants argued that "[A] commercial mortgage-backed security deal . . . does not provide for personal liability 100 percent of the time Not 90, not 95, not 99 . . . [A]sk anyone in the entire universe." *Id*. Apparently not pleased

continued on page 17

with the strident tone of Defendants' arguments in this regard, the court rejected these assertions and stated that:

> What Defendants seem not to grasp is that the court does not sit to propagate or enforce best business practices; instead, it is the court's duty to give effect to discrete agreements executed by individual parties. When those agreements provide that the occurrence of a springing recourse event makes a borrower or its guarantor personally liable for a commercial mortgage debt that would have otherwise been nonrecourse, the court will hold those parties to their bargain.

Id.

The court further stated that "Defendants are bound by the terms of the Loan Agreement they actually signed," *Id* at *16, noting that Defendants (who were represented by sophisticated counsel) were free to negotiate more favorable terms in the Loan Agreement with respect to the non-recourse language in the loan documents, but failed to do so.

B. The *Cherryland* Decision

In another recent case, *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership*, 2011 WL 6785393 (Mich. App. Ct., Dec. 27, 2011), based on facts similar (but not identical) to those in the *Chesterfield* case, *supra*, the Michigan appellate court held, in connection with a securitized commercial real-estate loan that had been assigned to the plaintiff lender ("Wells Fargo"), that the borrower ("Cherryland") and the individual guarantor (collectively, "Defendants") were liable for the entire loan deficiency of $2.1 million because the borrower was insolvent and had thereby violated the note and mortgage covenants regarding the borrower's failure to maintain its status as a special purpose entity ("SPE").

The court began its decision with a lengthy and comprehensive analysis of the structure of CMBS loans and the concept of "asset isolation," as described by the Commercial Mortgage Securities Association and the Mortgage Bankers Association. The court then rejected Defendants' initial argument that Wells Fargo's foreclosure of the mortgaged property at a Michigan non-judicial foreclosure sale extinguished the mortgage, holding instead that Michigan law was clear that "actions at law are permissible for deficiencies on foreclosures by advertisement." *Id*. at *4. The court then ruled that Wells Fargo was entitled to specific enforcement of the language regarding solvency in the mortgage provision entitled "Single Purpose Entity/Separateness," under which one of the covenants provided that Cherryland would remain solvent and pay its debts and liabilities from its assets as they became due.

The court acknowledged that "there are no cases that have held that insolvency is a violation of SPE status," *Id*. at *9, but quoted at length from a copy of a transcript, provided by Wells Fargo, of a 2001 hearing in *Wells Fargo Bank Minnesota, NA v. Leisure Village Assoc*, Wayne Circuit Court, Docket No. 00–031860–CZ. According to the *Cherryland* court, "The *Leisure Village* documents are slightly different and, arguably, more clearly written, but suggest the same result." *Id*. at *12. The *Cherryland* court noted that the *Leisure Village* case "dealt with, and rejected, all of the arguments made by defendants in this [*Cherryland*] case." *Id*. at *13. The *Cherryland* court held that in this case the particular language regarding insolvency required Cherryland to remain solvent in order to maintain its SPE status; thus its failure to do so triggered "full recourse against the

continued on page 18

continued from page 17

borrower and the guarantor pursuant to the loan documents," *Id*. at *6, and it was irrelevant which of the listed covenants in the "Single Purpose Entity/Separateness" mortgage provision was actually breached.

The *Cherryland* court quoted the trial court decision in *Leisure Village* that such relief "seems extreme" and that the loan possibly could become recourse if the borrower ever failed to pay *any* debt, but the *Leisure Village* court noted that the loan agreement executed by the parties provided that the exceptions to nonrecourse were placed in the mortgage "in order to induce Wells Fargo to make the loan and that (similar to the court's reasoning in the *Chesterfield* case, *supra*) " [t]he borrowers were apparently not able to negotiate for less strict language and this Court declines to write it into the contract." *Id*. at *10. The *Cherryland* court also rejected Defendants' argument that they should not be personally liable because the borrower's insolvency was not caused by its own actions, but rather by the downturn in the real-estate market, holding that "any failure to remain solvent, no matter what the cause, is a violation." *Id*. at *11. *See also LaSalle Bank N.A. v. Mobile Hotel Properties, LLC*, 367 F. Supp. 2d 1022, 1029-31 (E.D. La. 2004) (ruling that carveout provision in nonrecourse mortgage providing that debt would become fully recourse to borrower and guarantor if borrower failed to maintain its status as single purpose entity was triggered by borrower's amendment of its limited liability company Articles of Organization, without lender's knowledge or consent, to provide that borrower could engage in other activities, thereby making mortgage a full-recourse obligation), court stated that "motive . . . is . . . irrelevant").

Amicus Curiae briefs were filed arguing on behalf of Defendants in the *Cherryland* case, alleging that Defendants should prevail as a matter of public policy. But the court rejected the public-policy arguments raised by the amici, finding (similar to the court's holding in the *Chesterfield* case *supra*) that it was the role of the legislature, and not the court, to address matters of public policy.

As was the case in *Chesterfield*, *supra*, the court's ruling in *Cherryland* was based on the court's strict construction of the language in the nonrecourse and carveout provisions in the loan documents, which was (as pointed out by the court in each of these cases) negotiated and drafted by experienced and sophisticated parties. As stated by the court in *Cherryland*, "It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract." *Id*. at *11.

See also GECCMC 2005-C1 Plummer St. Office Ltd. Partnership v. NRFC NNN Holdings, LLC, 2012 WL 1035318 (Cal. App. 2 Dist., March 29, 2012), in which the plaintiff lender ("Plummer") held a $44 million mortgage loan secured by two commercial properties owned by the borrower, both of which were leased to a single tenant, Washington Mutual Savings and Loan ("Washington Mutual."). An affiliate of the borrower executed a guaranty agreement under which it agreed to be personally liable if "without the prior written consent of [Plummer, either lease] is terminated or cancelled." Washington Mutual eventually abandoned the properties and ceased paying rent, causing the borrower to default under the mortgage loan. Plummer commenced a non-judicial foreclosure proceeding and bid in $11 million at the sale of the properties, then sued the guarantor for the $42 million balance due on the loan plus attorney's fees and costs. The California appellate court, overturning the decision of the trial court in favor of Plummer, ruled that the guarantor was not personally liable

continued on page 19

continued from page 18

because the lease had not been "terminated" in the manner prescribed by the applicable California statute or as specifically set forth in the leases and the loan documents. According to the court, "neither the lessee's failure to pay rent nor its abandonment of the property terminates the lease." *Id*. at *2. The court noted that the guaranty was never triggered because under the loan documents (as well as the leases), the specific carveout exception to the nonrecourse provision regarding termination of the leases could only occur if the landlord (and not the tenant) terminated the leases, and this had not occurred because "it is undisputed that Borrower never gave notice of termination to Washington Mutual." *Id*. The court rejected Plummer's attempt to characterize the facts in this case as similar to those in the *Cherryland* case, *supra*, by arguing that although the lease-termination provision resembled a "bad boy" guaranty, "in reality it operates like an absolute guaranty because full recourse is triggered regardless of whether the lease is terminated by the tenant or the landlord." *Id*. at *3. The court stated that:

> The argument fails even assuming that we would follow the *Cherryland* opinion because it is based on a faulty premise — that the leases were terminated. Only *Borrower* had the right to terminate the leases and it is undisputed that Borrower never did so. For the same reason the decision by Washington Mutual's successor-in-interest to "repudiate" the leases did not trigger the guaranty.

Id.

As in the *Cherryland* case, *supra*, the court focused solely on the specific language in the loan documents (and the leases), except in the *Plummer* case such an analysis served to relieve the borrower from paying a $42 million deficiency. For commentary on the *Plummer* case suggesting that the court was correct in not following the *Cherryland* decision, *supra*, see Prof. Dan Schechter, *When Bad Boy Guaranty is Conditioned On Termination of Lease, Tenant's Abandonment of Premises Does Not Terminate Lease Or Trigger Guarantor's Liability*, 2012 COMM. FIN. NEWS, 27 (April 2, 2012). *See generally* Prof. Dan Schechter, *Liability Under Nonrecourse Carve-Out Guarantee Is Not Triggered By Parent Corporation*, 2011 COMM. FIN. NEWS. 9 (Jan. 31, 2011) (discussing New York District Court case, *Madeleine L.L.C. v Street*, 757 F.Supp. 2d 403 (S.D.N.Y. 2010) , which held that nonrecourse guaranty of individual guarantors under nonrecourse mortgage loan regarding unauthorized cash transfers was not triggered because specific language in documents referred to transfers made by parent corporation rather than transfers by subsidiary); Prof. Dan Schechter, *Carve-Out Guarantees Are Not Triggered By Borrowers' Dismal Financial Statements, Which Are Not Express Admissions of Insolvency*, 2010 COMM. FIN. NEWS. 54 (July 5, 2010) (discussing New York appellate decision, *D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquisitions, Inc*., 902 N.Y.S. 2d 93 (App. Div. 1st Dept. 2010), which the author summarizes as follows:

> [The *Zwirn* case] has held that the liability of a guarantor under a "carve-out guaranty" is not triggered by the mere existence of the borrowers' dismal financial statements, which did not rise to the level of express admissions of insolvency.

Conclusion

The *Chesterfield* and *Cherryland* cases, *supra*, have certainly gotten the attention of mortgage lenders and commentators. *See, e.g.,* Prof. Dan Schechter, *Borrower's Default*

continued on page 20

continued from page 19

and Insolvency Constitute Violations of "Separateness" Covenants, Thus Triggering Recourse Provisions in Note and Guarantee, 2012 COMM. FIN. NEWS. 4 (2012) (discussing *Cherryland* case and arguing that "bad act" of borrower's insolvency was attributable solely to circumstances beyond its control and that an allegedly nonrecourse obligation is meaningless if it only exists until default occurs); *Guarantor Liability: Nonrecourse Carveouts Triggered by "Insolvency,"* 41-Mar REAL EST. L. REP. 3, 3 (2012) (discussing and analyzing court's holding in *Cherryland*, and suggesting that unjust enrichment of lender perhaps should have been considered by the court as an "equitable" factor warranting reformation); *Insolvency Violates SPE Requirement*, 24 No. 17 COM. LENDING LITIG. NEWS 11 (2012) (discussing *Cherryland* case and noting that based on Michigan appellate court's interpretation of applicable loan documents "and persuasive authority from other courts," "Wells Fargo could pursue its recourse remedy and obtain a deficiency judgment because the mortgage unambiguously required Cherryland to remain solvent to maintain its SPE status"); Joseph Philip Forte, *Topsy-Turvy; The World of Commercial Real Estate Finance Turned Upside Down*, REAL ESTATE LAW & INDUSTRY REPORT, 5 REAL 180, Bloomberg BNA (March 20, 2012), which discusses in detail the *Chesterfield* and *Cherryland* cases and states that:

> [The *Chesterfield* and *Cherryland* decisions] have awakened the real estate finance markets – both Main Street and Wall Street – to vastly different legal liability and unexpected economic consequences than they had previously understood that loan documents imposed on them in typical securitized mortgage transactions. Unfortunately, the court seems to have disregarded not merely what the individual participants in the loan transaction – lender, loan buyer, securitizer, as well as borrower and guarantor – intended and believed the loan documents provided when they closed, but as a consequence has effectively dismissed as irrelevant the well-recognized intentions and widespread understanding of the entire real estate finance industry of the structures its various constituents developed for capital markets financing of commercial properties over the last 20 years.

The guarantor in the *Cherryland* case has made application for leave to appeal the Michigan appellate court's decision, and several parties (including the Michigan Attorney General) have made application to file Amicus briefs in support of the borrower/guarantor. (The author understands that the *Chesterfield* case also is in the process of being appealed.)

Taking to heart the court's admonition in *Cherryland* that that it is the role of the legislature, and not the court, to address matters of public policy, the Michigan legislature quickly passed a bipartisan bill, S.B. 992, which was introduced on February 29, 2012. The bill, to be known and cited as the Nonrecourse Mortgage Loan Act ("Act"), was signed into law by Gov. Rick Snyder on March 29, 2012. The Act regulates the enforceability of certain loan covenants in nonrecourse commercial loans in Michigan and is a direct result of the holdings in the *Chesterfield* and *Cherryland* cases, effectively making the deficiency judgments rendered in those cases unenforceable and overturning those rulings. According to the Committee Summary regarding S.B. 992:

> The bill would create the "Nonrecourse Mortgage Loan Act" to do the following:

continued on page 21

continued from page 20

-- Prohibit a post closing solvency covenant from being used as a nonrecourse carveout or as a basis for any claim against a borrower, guarantor, or other surety on a nonrecourse loan.

-- Specify that a noncompliant provision in loan documents would be invalid.

-- Specify that the Act would not prohibit a loan secured by a mortgage from being fully recourse to the borrower or guarantor, if the loan documents did not contain nonrecourse provisions.

-- Include statements of legislative recognition and intent.

The Act provides that any provision in the loan documents that does not comply with the prohibition against a post-closing solvency covenant from being used, directly or indirectly, as a nonrecourse carveout or as the basis for any claim or action against a borrower, guarantor or other surety would be invalid and unenforceable (Secs. 3(1)and (2)). The Act also contains a definition of "Nonrecourse carveout" (Sec. 2(a)), "Nonrecourse loan" (Sec. 2(b)), "Nonrecourse provisions" (Sec. 2(c)), and "Post closing solvency covenant" (Sec. 2(d)). The Act does not prevent mortgage loans secured by property in Michigan from being fully recourse to the borrower or guarantor if the loan documents do not contain nonrecourse provisions (Sec. 4).

The Act further states (Enacting section 1), in part, that:

The legislature recognizes that the use of a post closing solvency covenant as a nonrecourse carveout, or an interpretation of any provision in a loan document that results in a determination that a post closing solvency covenant is a nonrecourse carveout, is inconsistent with this act and the nature of a nonrecourse loan; is an unfair and deceptive business practice and against public policy; and should not be enforced. It is the intent of the legislature that this act applies to any claim made or action taken to enforce a post closing solvency covenant on or after the effective date of this act; to any claim made to enforce a post closing solvency covenant that is pending on the effective date of this act; and to any action to enforce a post closing solvency covenant that is pending on the effective date of this act, unless a judgment or final order has been entered in that action and all rights to appeal that judgment or final order have been exhausted or have expired.

The foregoing excerpt is likely intended to bolster the "public policy" argument for the Act as necessary to protect the perceived intent of the parties and to blunt any future legal challenges based on constitutional or other legal grounds, and to prevent the existing *Chesterfield* and *Cherryland* opinions from being effective regardless of whether or not the pending appeals from these decisions are successful.

It is likely that as a result of the respective federal and state court decisions in *Chesterfield* and *Cherryland* (notwithstanding the passage of the Act), attorneys for lenders and borrowers (especially in connection with CMBS loans and commercial loans on property in states other than Michigan) will in the future negotiate and draft nonrecourse provisions in loan documents (including separateness covenants and isolation of cash flows) much more carefully and precisely to prevent any similar "semantic"

continued on page 22

Enforceability of Carveouts ...
continued from page 21

issues from occurring. The *Chesterfield* and *Cherryland* cases arguably may be limited by their specific facts (notably the strict analysis and interpretation of the language contained in the nonrecourse and carveout provisions, which, as noted by the court in each case, was in its view not ambiguous or subject to reformation), but it serves as a "wake-up call" with respect to negotiating and drafting non-recourse provisions (and carveouts thereto) to reflect exactly the parties' intentions and expectations. Careful borrowers' and guarantors' attorneys have in fact negotiated out the "offending" language in non-recourse carveout provisions (i.e., insolvency covenants, "fail to pay" covenants, and certain SPE covenants) in the past with respect to CMBS (and other commercial) loans. As noted earlier, the court in *Chesterfield* stated that Defendants were free to negotiate the terms of the non-recourse carveout provision that were more favorable to their interests, but failed to do so. The role of the borrower/guarantor's attorney is crucial in this connection. For example, if the borrower/guarantor's attorney discussed this issue with the borrower/guarantor and was unable to negotiate out the offending SPE and insolvency provisions after warning the borrower/guarantor of the possible negative consequences, there may be no cause for a court to order reformation to conform to the alleged intent of the parties. ■

Meetings Calendar

2012 Annual Meeting
October 18-21, 2012
Renaissance Hotel
Chicago, IL

2013 Mid-Year Meeting
March 14-17, 2013
Naples Grande Resort
Naples, FL

2013 Annual Meeting
October 24-27, 2013
Four Seasons Hotel
Vancouver, BC, Canada

2014 Mid-Year Meeting
March 27-30, 2014
Grand Hyatt Kauai Resort and Spa
Kauai, HI

2014 Annual Meeting
October 16-19, 2014
InterContinental Hotel
Boston, MA

New on the Online Member Roster

Committee participation has been added to the Member Roster. Please check your listing! Involved with a committee not listed? No longer involved with a committee on your list? Please let the committee chair or Henri know, in order that your page on the website may be updated. This can be a very useful addition to the member pages, but only if the listings are accurate. While you are at it, check your Areas of Participation. You may reach Henri by calling the ACREL office, 301-816-9811, or by e-mail at hlkeller4501@acrel.org. ■

ACRELades

Lynn R. Axelroth was installed as the public director for the National Council of Architectural Registration Boards, an organization composed of the architectural registration boards of all 50 states, DC, Puerto Rico, Guam and the US Virgin Islands.

Pamela Duffy was selected as the "Real Estate Lawyer of the Year" by Chambers at the first annual Women in Law Awards presentation in New York in February. The awards recognize the leading women in the legal profession nationwide.

David Frantze was named a member of *Midwest Real Estate News'* Commercial Real Estate Hall of Fame 2011. In its second annual issue, the Hall of Fame publication highlights the careers of the most accomplished commercial real estate professionals in the Midwest.

At the Annual Meeting of the 4600-member Real Property Law Section of the New York State Bar Association, **Karl B. Holtzschue** received the Section's Professionalism Award, its highest award. He was Chair of the Section from 2007-8.

Wayne S. Hyatt has been awarded the Gurdon Hall Buck Award, the highest honor given by the Community Association Institute's College of Community Association Lawyers (CCAL). The award is given at the discretion of the CCAL Board of Governors in recognition of exceptional leadership in the field of community association law and a history of significant contributions in the areas of community association documentation, scholarly articles, legislative proposals, education, and mentoring of others. The award is named in honor of late ACREL member **Gurdon Hall Buck**, a pioneer and innovator in the field of community association law who passed away in 2008.

Gail L. Mills has been recognized by Chambers USA as a leading practitioner in Banking & Finance and Real Estate for 2012.

Arthur E. Pape has been selected the Chicago ***Best Lawyers*** **Real Estate Lawyer of the Year** for 2012. Best Lawyers is designating "Lawyers of the Year" in high-profile legal specialties in large legal communities. Only a single lawyer in each specialty in each community is being honored as the "Lawyer of the Year."

Larry Shulman is being honored for his business success, community involvement and impact on Maryland's economic growth and prosperity by being inducted into the Maryland Business Hall of Fame by the Maryland Chamber of Commerce. ■

Thank You *from the Programs Committee*

Following the Mid-Year Meeting held in Las Vegas in March, the Programs Committee received responses to the electronic evaluation survey from 130 of the 215 Fellows registered for the Meeting. The response rate was 60% which is much higher than in past meetings. The Programs Committee takes your evaluations very seriously as they are essential to our ability to continue to plan and provide the College with the highest quality CLE programming. To all who participated, a sincere "Thank You!" We look forward to more great programming at the Annual Meeting in Chicago, October 18-21, 2012. Mark your calendars. ■

David Gordon
Vice Chair, Evaluations