ACREL News

President's Message

As we near the end of 2010, we reflect on the significant progress and achievements of our organization this year. Our substantive committees have hummed with activity, our call-in programs have been informative and well-attended, and our two main meetings offered Fellows cutting-edge programs. Between these meetings, ACREL Fellows gathered for luncheons in Washington and New York, had drinks and conversation in Philadelphia, and met informally in other locations around the U.S. These gatherings exemplify the collegiality of the College, and underscore the importance of having opportunities to connect with each other. We have much to be thankful for as an organization, and I want to thank each of you for your support, generous giving of your time and talent, and your commitment in making ACREL the premier organization of real estate lawyers in the United States.

Toronto Meeting

The 2010 Annual Meeting in Toronto was, in a word, excellent. The Thursday afternoon session was kicked off by an interactive discussion with Andrew Trickett, Senior Vice President of Oxford Properties Group, and Jan Sucharda, President and Chief Operating Officer Brookfield Properties Corporation's Canadian Commercial Operations. Andrew and Jan gave insightful views into today's commercial real estate market. The Friday and Saturday programs and workshops were first-rate from beginning to finish. My thanks to **Meg Meister** and her committee in working to make the educational programming such as success, and to **Jill Pace** and **Henri Keller** in making the entire program run flawlessly. The festivities were capped off on Saturday evening by an Monopoly-themed party, imaginatively styled as "Acrelopoly." **Mike Rubin** reprised his ACREL-cabaret role after Saturday's dinner, which led to wonderful singing and laughter. Over 240 Fellows and their guests attended the Toronto meeting, which is remarkable given the location and the economic climate. Please take a moment to enjoy photographs from the meeting at http://www.acrel.org/Private/DrawDetails.aspx?Action=ViewDetails&TextItemID=18.

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Board Endorses Uniform Partition of Heirs Property Act

The Board of Governors unanimously endorsed the Uniform Partition of Heirs Property Act at the 2010 Annual Meeting. The purpose of the Act is "to remedy the serious problems many of those who own family real property have faced in keeping their property and their wealth as a result of the application of the default rules governing tenancy-in-common property by providing a further set of coherent, default rules reforming the worst substantive and procedural abuses that have arisen in connection with the partition of tenancy-in-common property." **Greg Stein**, ACREL's observer to NCCUSL on this model act, generously gave of his time and energy in keeping the officers and Board apprised of the progression and status of the Act.

Wait Until You See What the ACREL Committees Are Doing!

Fellows who are active with a substantive committee are aware of the terrific projects of that committee, but few Fellows know about the tremendous breadth and depth of projects across the board. We have posted a chart on the website that summarizes the recent and planned activity of all the substantive committees. http://www.acrel.org/Private/DrawCommitteeContent.aspx?Action=CommitteeContent&CommitteeContentID=1908 Take a minute to read through it, and see if there is a committee project for you. For newer Fellows, this also allows you to identify a committee or two you'd like to join. If you are interested in joining a committee, please email or call Linda Striefsky.

Common Interest Ownership Committee Creates New Subcommittee

The Common Interest Ownership Committee, under the skillful leadership of chair **Foster Gaillard**, has created a new subcommittee to work with and serve as a resource to the U.S. Department of Housing and Urban Development in connection with possible revisions to the Interstate Land Sales Full Disclosure Act. **Rebecca Fischer** and **Bill Sklar** will serve as co-chairs of this subcommittee.

E-CLE Programs Update

Call-in Seminar. ACREL's Capital Markets and Real Estate Finance Committee produced a free call-in program on November 17. Steve Waters, the committee co-chair, moderated a panel of experts from Holliday Fenoglio Fowler. Almost 100 ACREL Fellows called into the program, and it is likely that the number of those listening to the program was significantly greater because ACREL encourages colleagues of Fellows to listen in on these calls.

ALI-ABA/ACREL Joint Program. On December 1, ALI-ABA and ACREL will co-sponsor a program entitled

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STAFF BOX

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"Alternative Fee Arrangements for Real Estate Lawyers." The speakers will include ACREL Fellow **Michael Ostermeyer** along with Marie Lefton and Joseph Bauer. Michael and Marie debuted this acclaimed program at the 2010 mid-year meeting in Terranea. Discounted registration is available for ACREL Fellows. Please see the ACREL website for further registration information.

Program/Meeting Updates

Tucson (2011 Mid-Year Meeting). Mark your calendars for the 2011 Mid-Year meeting at Loews Ventana Canyon Resort in Tucson on March 17-20, 2011. **Rob Freedman,** who is spearheading the planning of the program for this meeting, has been working with the Programs Committee since this summer to identify programs and speakers for this meeting. The Programs Committee has been working hard to make this program as cutting edge and informative as possible.

Philadelphia (2011 Annual Meeting). For those who like to plan far in advance, the 2011 annual meeting will be held October 20-23 at The Westin in Philadelphia. **Larry McLaughlin** and **Jay Neveloff** have begun the time-intensive task of planning the educational programs for this meeting.

Kevin L. Shepherd
President

In Memoriam

It is with sadness that we acknowledge the recent passing of several Fellows:

Stan Samuels, on October 5, in Portland, Oregon. Stan was elected to ACREL in 1994 and was with Bateman Seidel Miner Blomgren Chellis & Gram in Portland.

Mel Mitzner, on October 16, in New York. Mel was elected to ACREL in 1992 and was a senior counsel at Keane & Beane in White Plains at the time of his passing.

Michael Marks, formerly of Hawaii, in early October. Michael, elected to ACREL in 1993, had retired to Colorado.

We also mourn the passing of one of our newest Fellows, **Susan Fowler McNally**, of Gilchrist & Rutter in Santa Monica, who died of cancer December 1.

Receivership Law Update

by Samuel H. Levine, Arnstein & Lehr LLP, Chicago, IL

Introduction

The law regarding receiverships in foreclosure proceedings continues to evolve. This article addresses four recent significant cases involving receivers and foreclosures that have been recently published; one in Florida, one in Indiana, and two in Illinois. The cases address issues such as the ability of the receiver to sell real estate, the difficulty in defending against a motion for the appointment of receiver, and the burden of the mortgagor in opposing the appointment of a receiver.

There is no uniform law governing state foreclosure receiverships. The standards and burdens for appointing receivers vary from state to state. For example, in Illinois a mortgagee is entitled to the appointment of a receiver without much more than a showing of the mortgagor's default and a provision in the mortgage entitling the mortgagee to a receiver upon default.[1] Other states require a showing of actual or threatened waste or that the value of the mortgagee's security is inadequate.[2] The recent cases discussed in this article address the issues that a mortgagee may encounter in obtaining a receiver or a mortgagor may encounter in defending against the appointment of a receiver in a mortgage foreclosure proceeding.

Recent Case Law (Florida and Indiana)

In *Key Bank Nat'l Ass'n v. Knuth Ltd.*, 15 So.3d 939 (Fla. App. 3 Dist., 2009), the Florida appellate court addressed the burden on the mortgagor in defending against a motion for the appointment of a receiver and whether a receiver could be appointed pending a show-cause hearing for violation of a court order enforcing an assignment of rents.

The court entered an order enforcing the assignment-of-rents clause contained in the mortgage. The court ordered that: (a) the rents could only be used to maintain and operate the property; (b) any excess rent was to be deposited in the registry of the court; and (c) a complete accounting was to be provided monthly to the court and the mortgagee. The mortgagors did not comply with the court's order enforcing the assignment of rents. The court therefore ordered the mortgagors to show cause why they should not be held in contempt for failing to comply with the court's order. The mortgagee then filed an emergency motion for appointment of a receiver.

At the hearing on the motion for appointment of receiver, it was undisputed that the mortgagors had not complied with the court's order enforcing the assignment of rents. The court ruled that a receiver could not be appointed unless certain requirements were met, such as the showing by the mortgagee of a substantial likelihood that it would prevail on the merits at the conclusion of the case or the failure of the mortgagor to use the rents and profits to pay the mortgage, if the rents and profits were pledged as additional security. The court noted that when the rents and profits are expressly made a part of the security, the burden is on the mortgagor to demonstrate that the value of the property is sufficient to pay the debt and

1 *See, e.g.*, *Travelers Ins. Co. v. LaSalle Nat'l Bank*, 200 Ill. App. 3d 139 (2nd Dist. 1990).

2 *See, e.g.*, *Atco Construction & Development Corp. v. Beneficial Savings Bank, F.S.B.,* 523 So. 2d 747 (Fla. App. 1988); *Dart v. Western Savings & Loan Association*, 438 P. 2d 407 (Ariz. 1968); *Mutual Benefit Life Ins. Co. v. Frantz Klodt Son, Inc.*, 237 N.W. 2d 350 (Minn. 1975).

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charges due under the mortgage. The court held that a show-cause order would not delay the appointment of a receiver and that commission of waste was not a necessary element for the receiver's appointment in this case.

In *Wells Fargo Bank N.A. v. Tippecanoe Associates, LLC*, 923 N.E. 2d 423 (Ind. App. 2010), the issue before the Indiana appellate court was whether the trial court erred in a mortgage foreclosure case when it gave the receiver the authority to sell the mortgaged real estate at a private sale without the mortgagor's consent and before a sheriff's sale could be held. Indiana has both a general receivership statute and a more specific foreclosure statute, which governs receiverships in mortgage foreclosure actions. The general receivership statue provides a non-exhaustive list of powers a trial court may grant to a receiver, including selling property in the receiver's own name.

The court described the receiver's role as taking possession of the mortgaged property, collecting the rents, issues, income and profits therefrom and applying them to the payment of taxes, assessments, insurance premiums, and repairs required, in the judgment of the receiver, to preserve the security of the mortgage debt. In this case the court applied the more specific statute pertaining to the subject of mortgage foreclosures over the more general receivership statute, and ruled that the receiver's powers did not include the right to sell the mortgaged property at a private sale. The court reasoned that the only "sale" contemplated by Indiana statutes governing receiverships over mortgaged property is a sheriff's sale.

Under Indiana law, the mortgagor is entitled to redeem its property from foreclosure up to the date on which the property is sold by the sheriff. The court in *Wells Fargo* was concerned that granting the receiver authority to sell the mortgaged property at a private sale, without the mortgagor's consent and before a sheriff's sale, would essentially eliminate the mortgagor's statutory right of redemption which, in this case, was not validly waived by the mortgagor.

The *Wells Fargo* case is interesting because of the "hot-button" issue of whether and under what circumstances a receiver can sell the mortgaged real estate. What would have been the outcome if the mortgagor, mortgagee and receiver all agreed to the sale of the real estate but mechanics lien claimants or junior mortgagees objected to such a sale? If the only impediment to the sale of the property was the redemption period, why couldn't the court order that the property be sold while preserving the redemption period?

Recent Case Law (Illinois)

The mortgagee's burden in defending the appointment of a receiver in the context of a commercial mortgage foreclosure was the subject of two recent Illinois cases: *Centerpoint Properties Trust v Olde Prairie Block Owner, LLC,* 398 Ill App 3d 388 (1st Dist 2010) and *Bank of America, N.A. v. 108 N. State Retail LLC.*, 401 Ill. App 3d 158 (1st Dist. 2010).

In both cases, the mortgagee met its statutory burden under Illinois law of showing that (1) the mortgage or other written instrument authorized the appointment of a receiver and the mortgagee's possession of the mortgaged property, and (2) there was a reasonable probability that the mortgagee would prevail upon a final hearing. Therefore, the courts in both cases held that the burden shifted to the mortgagor to establish good cause to retain possession.

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In *Centerpoint*, the court rejected the defaulting mortgagor's contention that it had shown good cause to retain possession because the mortgagee failed to allege any fraud, mismanagement, waste or other dissipation of the mortgaged property. The court rejected this argument as attempting to shift the burden of making a good-cause showing to the mortgagee. The court also rejected the mortgagor's arguments that it could better manage the property and the harm caused by the appointment of a receiver outweighed any harm the mortgagor might incur if it were permitted to retain possession. Therefore, arguments that the appointment of a receiver makes it difficult to attract prospective tenants, promote projects to investors, and obtain financing in order to resolve the foreclosure action will not in themselves defeat the appointment of a receiver in Illinois.

But the court in *Centerpoint* did acknowledge it could conceive of circumstances in which a court could find that good cause to retain possession has been established, e.g., where the mortgagor presents evidence that it has a commitment from an investor to provide funds for development of the property or has obtained a loan from another lender to refinance, and that the appointment of a receiver would likely impede those transactions. However, the transaction must be imminent and not at some unknown time in the future.

In *Bank of America*, the mortgagor contested the court's holding that the mortgagee had a reasonable probability of succeeding in the underlying foreclosure and had established the absence of good cause for the mortgagor to retain possession. The mortgaged property was the high-profile property in downtown Chicago known as Block 37. The defaults asserted by the mortgagee were: (1) the loan was out of balance and; (2) the failure of the loan guarantors to hold unencumbered liquid assets of at least $5 million as required by the loan agreement. The mortgagor had acknowledged in at least 23 previous letter agreements that: (1) it was in default because the loan was not "in balance" (i.e., the amount of funds available under the loan did not equal or exceed the amount budgeted to complete the project); (2) the guarantors failed to maintain the required $5 million in liquid assets; and (3) it had no counterclaims, defenses, setoffs, or affirmative defenses.

The mortgagor asserted two good-cause arguments, namely: (1) it was in the best position to complete the project and protect the value of the collateral, particularly given the project's complexity and the fact that the project was in its final stages of construction; and (2) the proposed receiver was unprepared to take over the project and had disqualifying conflicts of interest. The alleged disqualifying conflicts were:: (1) the receiver's employer, CB Richard Ellis ("CBRE") represented other properties in the immediate vicinity of the mortgaged real estate that were direct competitors for the limited pool of retail tenants seeking to lease space in downtown Chicago and (2) CBRE also represented several prospective Block 37 tenants, some of whom were involved in ongoing disputes with the mortgagor. The court held that the alleged qualifications of the mortgagor's current manager were insufficient to establish sufficient good cause to permit the mortgagor to retain possession and even though the mortgagor argued it was in a better position to complete the project, it had not presented a plan to obtain the additional funding required to complete the project, or indicate how it would be able to put the loan "in balance."

The court ruled that there was no indication that the proposed receiver was incompetent, inexperienced or incapable of managing

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the project and bringing it to completion. The court noted that CBRE was a large real-estate service company and that the individual proposed by CBRE to act as receiver for this property had acted as a receiver on twenty other large developments. Finally, the court ruled that the issue of an alleged conflict of interest would be appropriate for the trial court to decide.

Conclusion

Receivership law continues to evolve in response to the changing economic climate. Courts appear more amenable to appointing a receiver in order to protect the mortgaged property pending a foreclosure. A mortgagor's burden in defending against a receiver's appointment has become more difficult. The evolving areas of receivership law are the ability of the receiver to sell the mortgaged property and other related collateral, the terms and conditions of any such sale and the willingness of title insurers to insure a sale. ■

Added Stress to Distressed Real Estate or a Brief Primer on Cancellation of Debt Income

by Richard M. Heller, Law Offices of Richard M. Heller, and Robert G. Gottlieb, Venable LLP

In today's distressed commercial real estate market, one of the viable alternatives to a complete meltdown is the use of the restructuring of the real estate debt or, in the alternative to the workout, a short sale, a deed in lieu of foreclosure, or a foreclosure of the distressed property. While any of the above solutions is distasteful to the parties involved, the real hidden danger is the tax consequences of such an arrangement.

In general, any reduction in the principal amount of the mortgage by compromise or negotiation or other benefit of debt relief by modification of the mortgage terms in the absence of a mortgage foreclosure, voluntary conveyance of a deed in lieu of such foreclosure or abandonment will cause the mortgagor to recognize cancellation of indebtedness income, taxable at ordinary rates, to the extent of the cancellation. (Section 61(a)(12) of the Internal Revenue Code (I.R.C.)) See also United States vs. Kirby Lumber, 284 U.S. 1 (1931). Therefore, amounts of debt that are cancelled may be classified as income for tax purposes. The general rule of Section 61 (a)(12) (I.R.C.) provides that gross income includes income from the discharge of indebtedness.

Section 1017 of the I.R.C. (Discharge of Indebtedness) provides: "If an amount is excluded from gross income under Section 108 of the I.R.C. and any amount is to be applied to reduce basis, then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable

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year following the taxable year in which the discharge occurs". In other words, the relief that may be granted, while not incurring tax on such relief, will, in some cases, require a reduction in the basis of the property or other properties owned by the taxpayer.

Section 108 of the I.R.C. provides statutory relief from the recognition of income for debtors under certain circumstances. Judicial exceptions which may be available to postpone or eliminate the recognition of such gain must also be taken into consideration. Section 108 of the I.R.C. therefore provides classifications of relief to which the taxpayer may be entitled to forego the payment of taxes on such modification or cancellation of debt income. Section 108 provides relief from the taxable event if the discharge occurs in a Title 11 Bankruptcy case or if the discharge occurs when the taxpayer is insolvent, to the extent of the insolvency, or if the indebtedness which has been discharged is qualified farm indebtedness, or if the taxpayer is other than a "C" Corporation, the indebtedness discharge is qualified real property business indebtedness.

A discharge, which is occasioned by a title 11 Bankruptcy case, takes precedence over all other exclusions for gross income, and the insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion. If such a modification or cancellation of debt occurs, the lender is required to report the amount of the cancelled debt to the borrower and to the Internal Revenue Service on a form 1099-C (Cancellation of Debt).

Modification or Cancellation of debt income is temporarily suspended until December 31, 2013 or primary residences. Second homes or vacation homes do not enjoy the same exclusions from the imposition of the tax due on cancellation of debt income. Each state may have its own tax regime, which may also impact the transaction and should be analyzed in conjunction with the Internal Revenue Code requirements.

Additional information may be found in Publication 4681 – Canceled Debts, Foreclosures, Repossessions and Abandonments (for individuals) – at the website for the Internal Revenue Service www.irs.gov. The rules on cancellation of debt income are complex and the exclusions are nuanced. Any time the taxpayer, whether an individual or an entity, uses a debt relief technique, the tax consequences may be serious and a thorough analysis should take place prior to determining the proper structuring of any type of relief. ■

ACRELades

Bruce T. Block was named one of *Best Lawyers* "Lawyers of the Year," in Milwaukee.

Dean P. Gisvold was honored by the non-profit social service agency Central City Concern in Portland, OR, for his 24 years of service as Board Chair.

David L. Pollack became chair of the Program Committee for the International Council of Shopping Centers (ICSC) 2011 Law Conference.

Michael H. Rubin has been appointed by the President of the Louisiana Senate to serve a three-year term as one of Louisiana's three Commissioners on the national Uniform Law Commission (ULC).

Steven A. Waters was designated the San Antonio Real Estate Lawyer of the Year by *Best Lawyers*. ■

Illusory Contracts in California and New York (and in between)

*by Roger Bernhardt, Golden Gate University**

The adrenalin level of the California real estate bar rose up dramatically earlier this year when the California Supreme Court rendered its opinion in Steiner v Thexton, 48 Cal 4th 411, 226 P3d 359 (2010), a decision that seemingly redefined our rules concerning the enforceability of executory contracts for the purchase of property. At least a dozen law firm blogs about the case must have crossed my desk worrying about that decision.[1]

In *Steiner*, a putative buyer had sought specific performance of his arrangement to purchase 10 acres of land. The document had been executed in 2003, and gave the parties until 2006 to close, during which time the buyer was to obtain all the necessary entitlements for a development, and had in fact gotten many of them by the time of the seller's withdrawal in 2004.

Too Easy to Withdraw

What killed the buyer's case at trial (and at the intermediate court of appeal) was the clause that entitled him, at any time, at his "absolute and sole discretion" to withdraw from the contract. That provision, as far as the lower courts were concerned, made the buyer's promise to purchase illusory and converted the deal into an option, unsupported by any consideration; thus entitling the seller to withdraw at any time before the buyer accepted his offer.

That particular conclusion was solidly (and unanimously) endorsed by the Supreme Court. The backout provision converted the agreement into an option, and no implied covenant of good faith or fair dealing, or duty to act expeditiously in getting the permits could deconvert it. As a bilateral contract, it was – at the outset – illusory.

But Redeemed By Efforts Thereafter

But that was just Part 1 of the opinion. In Part 2, the court then ruled that the buyer's subsequent efforts towards getting the entitlements constituted enough consideration as to render the option irrevocable, meaning that the seller could no longer withdraw. Although the lower courts had opined that such efforts could not constitute consideration to support a contract because they had not been bargained for, the high court held that they were nevertheless sufficient as to have "cured the initial illusory nature of the promise and rendered the option irrevocable."

So that is now the situation in California. Professors may argue over its arguably dubious reasoning about consideration, and practitioners may have to give very uncertain advice as to part performance, but the rule of *Steiner* cannot be ignored, because the contract there looked so much like those commonly used throughout the state.

Different from other withdrawal provisions?

The California Association of Realtors (CAR) standard form Residential Purchase Agreement has an escape clause that gives buyers 17 days to "approve all matters affecting the property." That language looks like it might make an ordinary purchase agreement illusory under the first part of the *Steiner* opinion. The CAR has amended that provision to add, "Any

* Roger Bernhardt, a professor of law at Golden Gate University in San Francisco is a member of ACREL and Editor of the California CEB Real Property Law Reporter. His columns may be found at RogerBernhardt.com.

1 And there were probably a good many more blogs that went out, except that I am, unfortunately, not on their mailing lists. Please henceforth add me: .).

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removal of contingencies or cancellation under this paragraph by either buyer or seller must be exercised in good faith and in writing", but since the court's opinion rejected the implied covenant of good faith as a cure for illusory obligations, it is unclear whether an express covenant of good faith can function much differently.

The Supreme Court did attempt to distance itself somewhat from this threatening consequence by stating that the provision it was looking at was different from what is in standard real estate contracts. In a footnote, it declared, "Thus, bilateral contracts subject to a contingency, which are widely used in real estate transactions, are not affected by our holding." But while it may be easy enough to distinguish a contract made contingent on obtaining financing from one giving the buyer absolute discretion to withdraw, there are an awful lot of situations that fall in between those extremes. Can lawyers always tell which contingency provisions make their contracts illusory and which don't? More importantly, can brokers - the players who draft almost all of the residential sales contracts in California – do so?

Since the court's opinion did ultimately validate the *Steiner* contract, because of the subsequent efforts by the buyer in getting the development permits, will this new interpretation of our consideration requirement (not testing its adequacy solely as of the time the agreement was made), save many otherwise illusory contracts? But most conventional residential real estate contracts entail little activity by the purchaser during the escrow period that could qualify as consideration to the seller (such as what occurred in *Steiner*). That should not stop counsel for buyers from trying to get their clients' deals to fit under the first part rather than the second part of the opinion, and providing that all those activities, e.g., making the investigations, are recharacterized as being for the seller's benefit as well as the buyers, so that the buyer's performing of them may lock the seller in.

Adding Independent Consideration

More provocatively, the court threw into another footnote the rather gratuitous suggestion that it would not take too much original consideration by the buyer to make such a contract enforceable. It volunteered:

> "the agreement required Steiner to deposit $1000 into escrow, which he did. The trial court concluded the payment did not constitute consideration because Steiner would recover the money if he terminated the agreement; thus, the money did not confer a benefit on Thexton. However, even assuming the trial court's interpretation of the agreement is accurate, it is not clear that its ultimate conclusion is correct.... [B]y placing the money in escrow, Steiner gave up use of the money for as much as three years. This arguably constituted prejudice to Steiner even if he ultimately got the money back. In light of our conclusion regarding plaintiff's part performance, we need not resolve the effect of the escrow payment."

That footnote has been richly tempting to the bar, with many of the newsletters that I mentioned suggesting inclusion of a deposit arrangement looking more favorable to the seller – e,g, paid directly to the seller, or giving him the interest it earned, or made nonrefundable - might constitute sufficient independent consideration as to support the deal contract notwithstanding its inclusion of absolute back out rights. Indeed, given a sufficiently sympathetic court, a token payment for an option to purchase might be all that is necessary.

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(I am tempted to say that if that kind of "gimmick" is utilized, then it ought at least to be taken seriously, i.e. the $100 should actually be paid, except that even that may be unnecessary in jurisdictions that subscribe to the Restatement of Contracts (2d) position that offers can be enforced as binding option contracts if they simply recite a "purported consideration" (§ 87), even when the recitation is false!

Living With Free Looks

Whether or not it has gotten the drafting job right, our real estate industry has decided to tolerate revocable contracts to purchase houses, thereby giving purchasers a cooling off period, much like they have with regard to the loans that they apply for to complete their purchases (although 17 days is much longer than 3 days, and the counterparty is a private seller, who may have time concerns different from those of institutional lenders with thousands of loans in process at all times anyway). Isn't there some better alternative?

Several states include in their forms clauses making the deals subject to the review and approval of their parties' attorneys. These have been the subject of two good law review articles: *Attorney Approval Clauses In Residential Real Estate Contracts—Is Half A Loaf Better Than None?*, 48 U. Kan. L. Rev. 339, by Alice M. Noble-Allgire, a Law Professor at Southern Illinois University School of Law. written in 2000; and *Navigating Residential Attorney Approvals : Finding A Better Judicial North Star*, 39 J Marshall Law Review 171, 2006, by Debra Pogrund Stark, a Law Professor at John Marshall. Both authors survey the various clauses in use around the country and the reported decisions that have dealt with them. Both like the clauses but also believe that a requirement of good faith should be read into them.[2] Noble-Allgire thought that a good faith requirement should be incorporated in order to keep the contracts including them from being held illusory, whereas Stark wanted attorneys to have to exercise their disapprovals in good faith to avoid letting clients use this to extricate themselves from obligations they have simply changed their minds about.

Is Good Faith Essential?

These demands for good faith have not, however, been wholeheartedly accepted by the courts. With regard to keeping a contract from being illusory, in 2008 the Wisconsin Court of Appeals held that an attorney approval provision did not hurt a real estate sales contract so long as the right to cancel was limited "even in a slight way", such as having to consult with an attorney and provide notice within in five days. "In our view, these obligations, though not onerous, are enough to save the deal from being illusory." *Devine v Notter*, 753 NW2d 557 (2008). Having to pay an attorney a one time consultation fee may be a cheap price for getting out.

Even more violent in its opposition to a requirement that attorneys opine only in good faith is the decision by the New York Court of Appeals in *Moran v Erk,* 901 NE2d 187, also in 2008. The high court there was considering a form contract that is used by the Buffalo Association of Realtors and includes a standard three-business-day attorney approval clause. According to the court:

> "After signing the contract, the Erks developed qualms about purchasing the Morans' house. They discussed their misgivings with their friends and family,

2 Noble-Allgire also believes that such clauses should to be required wherever brokers rather than lawyers draft residential sales contracts, a proposal that should appeal to underemployed attorneys. Stark also wants to require a specification of the attorney's reasons for disapproving (but was careful to not require reasonableness, because not all attorneys are at the same level of competence).

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> and ultimately decided to buy a different residence. As a result, they instructed their attorney to disapprove the contract, and she did so on October 28, 1995, which was within the three-day period for invoking the attorney approval contingency."

In rejecting the sellers' claim for damages, the court of appeal held: "An attorney for either party may timely disapprove the contract for any reason or for no stated reason"

With regard to the claim that the implied covenant of good faith and fair dealing should limit the buyers' attorney's ability to disapprove, for the court said:

> "clarity, predictability, and professional responsibility" lead in the opposite direction. Outcomes would become "dependent on the subjective equitable variations of different Judges and courts instead of the objective, reliable, predictable and relatively definitive rules" of plain-text contractual language."

Even worse, the inquiry as to bad faith would:

> "likely require factual examination of communications between the disapproving attorney and that attorney's client… That is, the disapproving attorney will be subpoenaed to testify about communications the disclosure of which might be detrimental to that attorney's client-a direct conflict with an attorney's duty to preserve a client's confidences and secrets… Moreover, the threat to attorney-client confidentiality under a bad faith regime could harm the attorney-client relationship itself in the context of real estate transactions. A diligent attorney, cognizant of the risk of being subpoenaed to testify as to the basis for a disapproval, would face a perverse incentive to avoid candid communications with his or her client regarding a transaction in which the attorney is supposed to represent the client's legal interest."

That means that in New York, a buyer can back out in 3 or 5 days after her offer was accepted, so long as she does it through an attorney, which may be easier than what she has to go through in California, where she has 17 days to do so, but must hope that a judge will agree that she did so in good faith.[3] The letter that New York counsel must write should not cost much, since no reason need be given.[4] If the brokers want to give the public quasi-illusory real estate arrangements, why not let the lawyers profit from them. ■

3 It is unclear to whether the seller can do the same during those 17 days, and whether the contract really becomes nonillusory after that if the buyer put in no efforts in the interim.

4 And it is certainly cheaper than the practice in New York City of displacing broker generated forms with contracts drafted in their entirety by two attorneys, after the brokers have put the basic deal together. During the weeks that follow, while the attorneys are bickering over their rival favored form clauses, both parties are free to seek better deals elsewhere, thereby "gazumping" the other. It is a miracle that deals there ever close at all!

In Memoriam: Harris Ominsky

by Andrew Gowa, Gowa Lincoln, PC

On August 16, 2010, our beloved colleague and my friend and mentor of 37 years, Harris Ominsky, lost his battle against a particularly virulent form of bile duct cancer.

Harris was not only a Fellow of ACREL, active in its many projects for the quarter century that he was a member, and the longstanding editor of this Newsletter, but he was regarded as the "Dean of the Philadelphia Real Estate Bar," and will be missed by so many outside of ACREL as well as in the College. Well known for his incisive and often humorous writing, Harris authored over 800 articles; wrote a weekly column, "Ominsky's Terrain," in *The Legal Intelligencer*, Philadelphia's daily legal newspaper; and wrote two "must have" reference books, *Real Estate Practice: New Perspectives* and *Real Estate Practice: Breaking New Ground*. His articles, often peppered with anecdotes, folksy stories, and unconventional common sense wisdom, appeared not only in professional publications, but in local newspapers and magazines for laymen as well, as it was one of Harris' goals to make the law readily understandable to the public, not just to highly trained lawyers.

Harris was often a source for local reporters writing articles on real estate, because, as his wife Roz observed, "he had a knack for explaining legalese to the lay person, and used humor to do it." In 2000, he was interviewed by a Philadelphia *Inquirer* reporter for an article about landlords who were being pressed to house delegates for the GOP National Convention. He was quoted as saying, in typical Harris style: "If you don't like politicians, you can discriminate against them just because they are politicians. There are no rules about discriminating against people who aren't part of a protected class…."

He was a lecturer, course planner, and past president of the Pennsylvania Bar Institute, the educational arm of the Pennsylvania Bar Association. In 1988, he was the recipient of the Harrison Tweed Special Merit Award from the American Law Institute for his "exceptional contributions" to continuing education for lawyers.

When the Real Property Section of the Philadelphia Bar association first established its annual "Good Deed Award" in 1999, Harris was the first recipient, for his unceasing devotion to educating lawyers and lay people alike about the law. It was not surprising that at the Real Property Section's annual luncheon last month, the Philadelphia Bar Association announced that the accolade was being officially renamed "The Harris Ominsky Good Deed Award," and it was presented to this year's recipient by Roz and their daughter, Michelle O'Toole.

I first met Harris when I was a second year law student in 1973, serving a summer clerkship at Blank Rome Comisky & McCauley, where Harris spent 40 years practicing law. Another partner had given me the assignment of rewriting the customary form of residential lease, "the Form 50" that had been used throughout the Commonwealth for 25 years, into "plain, easy to read English that all tenants could understand." While seemingly an easy project, I soon discovered that I did not understand most of the archaic words in the form; it made Shakespearean English seem commonplace. After floundering in despair for several days, I asked a young associate for help, and he merely said, "do what we all do when we are stuck: go see Harris."

This began a vital and very rewarding mentoring relationship and friendship that spanned my entire career. Harris not only

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walked me through every archaic word and concept in the form lease, but he explained the context, its derivation, how the term evolved to mean something very different over time, and then pointed me to one or two recent articles or cases that would help me "get it." How, I wondered, did he know all of this and have it at his fingertips? I then learned about the secret treasure that Harris owned, but generously shared with everyone: Harris' huge 3-inch thick loose-leaf notebooks, then numbering a couple of dozen, bound in black or green vinyl, lining the walls of his secretary's alcove. Each brimming with articles, cases, commentaries and statutes, most with Harris' scribbled notes in the margin, about every possible field of real estate law --- and sometimes about other subjects that happened to tickle Harris' fancy at the moment. Back in the mid- 1970s, Harris' books were not voluminous, and the term "computer" was a science-fiction concept to lawyers, so the contents were not necessarily arranged in any particular order or classified by subject, though Harris did keep a master table of contents if one wanted to randomly thumb through it in the hopes of finding a word that related to your inquiry. When I left the Blank Rome firm in the mid-80s, the collection probably numbered well over a hundred volumes and was growing fast. Everyone at the firm knew that if Harris didn't have something on your esoteric question tucked away in his loose-leaf books somewhere, the piece you were searching for probably did not exist. Of course, Harris could lay his hands on the desired article almost automatically. The rest of us had to search. But the fact was that it was there, and everyone in the firm knew that Harris had not only saved it, but had carefully analyzed every article, kept notes on it, and could extemporaneously and very comprehensively explain to you every nuance --- or at least point you in the direction where you could find the details.

The only drawback for a young lawyer seeking answers from Harris was that he usually asked you more questions. I think there was something inside him that compelled him to challenge not only everything he read and was told, but to challenge everyone around him. But unlike some law professors or overbearing senior partners, Harris always challenged you in the gentlest style, never forcing you into a corner or making you feel stupid because you had no answer to his inquiry or could not approach his level of intellectual analysis. He would cock his head, and gaze out, and seem to quietly pose the question to the sky, almost as if he was alone, wondering out loud, all the while, of course, knowing that you could hear him. What a human, decent, nurturing way of challenging his companion's mind. One hardly knew Harris was challenging you until later in the day, when you found yourself thinking about Harris' questions, realizing how much more you had to learn and process in order to more fully comprehend the issue.

After leaving Blank Rome I became a real estate developer, and while I was able to handle much of my own legal work, I knew there were areas where I was weak and where I would be at financial risk if I did not have the best legal advice. I would call Harris to represent me. Being a smart-ass young kid at the time, with a background at a big firm, I wanted to make sure I did not spend a great deal of money on legal fees. So I concluded that I wanted the top person handling every aspect, not a young associate at a seemingly lower rate. I wanted someone who got to the important stuff quickly, knew all the issues and had the judgment to invest time only on the ones that really had economic or major risk implications; the smartest, quickest and most efficient person with the best judgment: Harris Ominsky. I remember to this day the late night closings with Harris. I was young, conservative by training, anxious and

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worrisome by cultural background, but I was taking big risks. Yet I felt extremely calm and comfortable because I knew that Harris knew exactly what he was doing, that he would do it well, that the other side (no matter who it was) respected and liked him and would accommodate him in every way possible because he was Harris Ominsky, a straight, honorable, decent, respectful and brilliant man who would not ask for anything outlandish or over-reaching (albeit that he might push the envelope to its justifiable limit), and who would be there to share his knowledge and help the opposing counsel out if called upon at any point in the future.

And I can remember vividly having dinner and a beer with Harris after late closings or negotiations, frequently at 11 p.m. or later at a TGI Fridays (they were the only places open that late), where we joked, recounted the days' events, talked about our wives and children, politics, his tennis game, etc. as if it were a leisurely lunch at 12 noon, not 12 midnight.

It did not end there. We kept up with one another and lunched from time to time until a year or so ago when he started to have limited time and strength to meet for lunch. And our lunch conversations were not all about the law by any means, as we both liked to talk about other things, especially our families and our children. He was so helpful in helping me fathom some of the challenges of parenthood, a path he had travelled many years before me, in his typical, understated, non-confrontational style.

Robin and I always looked forward to going out with Roz and Harris at ACREL events, too. In fact, at the first ACREL meeting we attended, my wife declared over dinner with Roz and Harris Friday that she would never attend another ACREL meeting because she felt so isolated, so much like an unwanted outsider. Starting the next morning, Harris took Robin under his wing and introduced her to everyone he knew during the next few days. Now, thanks to Harris' generosity, sensitivity and good heart, Robin looks forward all year to the next ACREL gathering.

While Harris was obviously an extremely bright mind, an excellent lawyer and talented writer, what I remember most about him are his warmth, caring nature, and gentle demeanor. This is what will stick with me forever, long after I forget how he analyzed Byzantine transfer tax issues.

I could continue with wonderful, warm Harris memories for pages, but when I first agreed to write this Harris retrospective, I contacted many folks, predominantly at ACREL and at Blank Rome Comisky & McCauley where Harris practiced for 40 years, and asked that they share any recollections or thoughts they had about Harris. The outpouring was quite overwhelming, and it dawned on me when I sat down to write this tribute to Harris that many of those who wrote were far more eloquent than I am. I believe that others have more poignantly captured the essence of Harris Ominsky, and therefore I share their words with you, Harris and Roz, below.[1]

Harris, Robin and I miss you. Peace be with you, my teacher, friend, advisor and mentor.

With love and appreciation,
Andy Gowa

1 I apologize to those whose input I failed to solicit or include, and to those whose comments I edited. The blame is all mine.

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Harris (hereinafter referred to as the " Ultimate Nice Guy" or "UNG") and I were young lawyers, new to real estate, when we were invited by a local title company to deliver presentations at a convention in the mid-60's. We became good friends at that point and remained good friends for more than 40 years. I had the privilege of working with the UNG on various seminars, CLE programs, and Bar committees over the years, and we often chatted at our synagogue, in the lobby of our office building, and elsewhere. If I had an especially thorny real estate problem, I might turn to the UNG, who was always--without exception-- thoughtful, courteous and helpful. He nominated me for ACREL in 1986.

When I learned that he was ill, I called. He was his usual calm, cheerful self. It did not occur to me that this would be the last time I would speak with my old friend, although I realize now that he must have known.

No doubt Harris was a fine lawyer, writer, mentor, and all the other good things people say. But, more than that, he was the Ultimate Nice Guy.

--Stuart F. Ebby

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Harris and I shared a love for the Chautauqua Institution in western NY state which has been described as a collision of divergent ideas, political viewpoints, age groups, faith traditions (Christian, Jew, Muslim, Buddhist), arts, recreation and learning where we would meet serendipitously each summer. Harris thrived in the excitement of the place. During chance meetings on Bestor Plaza or over ice cream in his condo, he was always ready to discuss the theme of a lecture, quality of a performance or the importance of a full, active life.

I always looked forward to his practical advice articles such as his description of a Letter of Intent from a Queen's Bench opinion: "A gentlemen's agreement is an agreement which is not an agreement, made between two persons neither of whom is a gentleman, whereby each expects the other to be strictly bound without himself being bound at all." Harris was a gentleman and scholar who graciously and generously shared his knowledge and insights with his profession. He leaves a void.

-- Don Beimdiek

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Dear Harris:

It is truly a privilege to know you, to have learned from you, and to have been associated with you over the years. I know a few people who are world class lawyers, and few others who are Menschen, but you are one of the rare people who are both.

Over the years, while I was a member of a "rival" law firm, I always looked up to you with great respect and admiration for your expertise, wisdom, insights, and professional demeanor. Any time an article was published by Harris Ominsky, I not only read it, but copied it and placed it in my reference files. If a legal seminar was occurring where you were the teacher, I would try to make it a point to be there to learn from you.

More than being an outstanding teacher, what is striking about you is your modesty, and how you always have kept learning. You fulfill the description of the qualities a wise man, given to us by the Jewish Sages, in Pirkei Avot (Teachings of the Fathers, 4:1): "Who is wise? He who learns from all people."

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In more recent years, it has been my honor to become a law partner with you at Blank Rome, and a colleague in the American College of Real Estate Lawyers (ACREL). When I came to Blank Rome as a lateral partner in 2007, you were kind, welcoming and very supportive of me. I was given an office that I later learned had been yours for many years. I took this as a sign. I would sit in the same place where Harris Ominsky once sat, a great honor and a blessing.

You have been a role model, guide, teacher and inspiration to many people. I am proud to say that I am among them. Thank you.

Sincerely,
Joseph S. Finkelstein

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Harris was a truly extraordinary person. Much can be said about his brilliant mind, often disguised by genuine modesty, and about his contributions to legal scholarship. Much can be said about his devotion to art and music and literature. Much can be said about his wonderful sense of humor and his creative thinking (cartoons for example). Among all these qualities, most of all I admired his loving and caring nature and the selfless manner in which he valued family and friends. After retiring, I was unable to see Harris at ACREL meetings, but nevertheless he called many times in order to nourish and sustain our friendship. During his illness, Harris spoke little about himself. He preferred to tell me about the wonderful care Roz was giving him and to chat about our mutual friends. He always had a way of thinking about others first. Harris was a good friend - the best.

-- Richard W. Dortch

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I have known Harris since I started practicing law. I know of no one who was more scholarly than Harris, yet very practical. No one was his competitor, and he was always willing to share his wisdom. I truly loved to brainstorm with Harris, and did so right up until his untimely death. I was recently asked to be an expert witness, and I miss being able to run the issue by him. I think about him often, and miss him dearly.

-- Bob Schwartz

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I was privileged to be Harris Ominsky's partner and friend for more than 35 years and to serve with him as co-Chair of Blank Rome's Real Estate Department. Harris was a mentor to me from my first days with the Firm through all of our years together, including his guidance in my membership and participation with ACREL. As everyone knows, Harris' writing skills were legendary, and he was always willing – and able – to share with me (and all of us at Blank Rome) his skills and insights. That extended not only to our legal practice, but also to many hours on the tennis court. Equally important, he led and taught with humor, grace and humility and made it easy to learn. We will miss him

-- Julian Rackow

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"Harris asks the best questions!" This was the annual exclamation of Chautauqua's short story interpretation class leader. Harris attended and participated in short story review religiously and conscientiously just as if it was a client briefing session or Torah study, applying his sharp mind and deft touch.

As in the law, Harris applied a special touch to his pursuit of a story's core. Participants

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never ostracized him as "a lawyer." Instead, his conduct led participants to respect the legal profession he treasured through his demonstration of not only traditional devotion to rationality, but also his acknowledgement of the human thread in every theme.

Harris and his bride Roz seemed to find summering at the Chautauqua Institute special because there, just as in ACREL, and the law generally, challenging of core values was encouraged in a framework of respect for differing opinions. Politics, religion, or art, Harris could be found every summer afternoon in Chautauqua's open air Hall of Philosophy. There notables would lecture with the prospect of audience questioning.

Attached are 2008 photos of Harris at the front of the line. Harris was there not to be seen, but as a lawyer's lawyer to put into respectful words the audience's thoughts and doubts. As the lawyer's lawyer, he was there to learn, and to pass on learning to the lecturer and audience.

To the end Harris' never wavered in his devotion to the concept of honest debate. Physically debilitated by his "novel cancer treatment" he shlepped to Chautauqua's lectures and short story review. Literally to the end he provided salient commentary. He was seen as and will be remembered as dedicated to the highest ideals of the profession and society.

-- Michael J. Gelfand

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The world has lost a bit of its humanity and dignity because of the passing of Harris Ominsky. Rita and I first met Harris and Roz ten years before we moved to Philadelphia. At Harris' first ACREL meeting, we were introduced by mutual friends and had a wonderful dinner. It was obvious that Harris was engaging, interesting and certainly knew how to turn a phrase. We later did a number of transactions on the opposite side and, of course, Harris was gracious and considerate as well as highly knowledgeable during the course of the deals.

When we moved to Philadelphia and I joined a major competitor of Harris' firm, he immediately embraced me, introduced me to other members of the Philadelphia Real Estate Bar and we often lunched together. It was then that I realized the importance of Harris to the Philadelphia and Pennsylvania bar. His prolific writing and interest in the education of the bar and the training and skill of younger lawyers was legendary. His writing also educated, amused and kept the reader looking for the next installment.

We will deeply miss Harris both in the Philadelphia community and in the ACREL family. His writing and demeanor has graced both of these venues.

-- Dick Goldberg
Past President of ACREL

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I spoke with Harris' wife, Roz, last week, to express my condolences on Harris' passing, and to mention a few of the fine experiences I had with Harris over the years, including his kindness in inviting me to sit with him and Roz at lunch when I was attending an ABA

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Real Property meeting by myself as a young lawyer. Harris was a fine example to those of us following behind him in the profession.

-- Cheryl A. Kelly

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I first met Harris at an ACREL meeting shortly after he was elected a member in 1985. At the time, I was either the President or the President-elect, I can't remember which. As we sat around a swimming pool at the Boulders Resort in Scottsdale, he approached me with thoughts about improving ACREL's then very nascent newsletter, which badly needed help. He basically volunteered to be the editor, and he had excellent ideas for content. Volunteers like that don't come along very often, and so I accepted his proposal immediately. The rest is history. ACREL was blessed with a diligent, clear-thinking legal commentator whose writing was not only cogent but creative and humorous---and, as everyone knows, he didn't just contribute for a year or two. He served faithfully right up until his passing. We all looked forward to each of his many thoughtful articles. The bonus for me was that my wife, Ann, and I became good friends with Harris and Roz, and we shared many dinners and other good times with each other both on and off the ACREL circuit. If they need a newsletter in Heaven, Harris is their man!

-- Bruce Lane
Past President of ACREL

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What made Harris unique was the absolute joy he found in scholarship and in writing about the law - it was like an unquenchable thirst for knowledge.

-- Herman Fala

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I considered Harris one of my closest friends among ACREL colleagues even though we saw each other only at meetings . I often asked Harris how he found the time to practice law and still have the enthusiasm for the considerable writing he did. I think the explanation is that Harris was the consummate student of the law and he never lost his thirst for the surprise that may be found in new cases. The workshop Harris conducted on how to ease into retirement and still make a valuable contribution to our firms and profession was one of the best I have attended.

Amy and I took a few side trips with Harris and Roz at ACREL meetings and one of my favorites was the cog railroad to the top of Pikes Peak where were struck by the majesty of the mountain and how the thin air made it difficult to breathe or exert the effort to walk . The train ride made the extreme climb effortless and Harris was like that, always seeking the summit to unravel the mystery of the law and making it seem effortless. I shall miss him greatly.

-- M. Jay DeVaney

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He will be missed by everyone; I miss him. It was always a delight to shoot the breeze with him about legal matters in general, and of course his specialty, real estate law. As a real estate lawyer, he had no equal. My wife Carla and I will miss greatly the wonderful times we had with Harris and Roz. Harris was what a gentleman and a lawyer should be.

-- James F. O'Rorke, Jr.

Standby Letters of Credit and Performance Bond Bonds: A Comparison

by David Callies & Kekoa Keiley, Wm. S. Richardson School of Law, Honolulu, HI

I. Introduction

Virtually all local governments require land developers to provide assurances that required or bargained for public facilities and some infrastructure will in fact be constructed. These assurances generally take the form of a performance bond. However, the standby letter of credit (LOC) may be an increasingly common alternative, given its advantages to local government. What follows is an overview and analysis of both forms of guarantee.

II. The Letter of Credit (LOC).

LOCs typically provide and are addressed to a government beneficiary or its Finance Director. They are often designated "irrevocable." They are also payable on "sight" so long as each LOC is accompanied by a statement that an authorized representative of the government beneficiary certifies that the amount drawn represents the amount due to the government beneficiary as (subdivision) improvements for [here a subdivision phase is listed] have not been completed by the developer.

There are three different parties involved in the issuance of a LOC: the issuer, the beneficiary, and the account party. These three parties have distinct, conflicting interests. Beat U. Steiner, *A Letter of Credit Primer for Real Estate Lawyers*, 28 Real Prop. Prob. & Tr. J. 125, 136 (1993). In general terms, the beneficiary wants to get paid no matter what happens; the account party wants to reimburse the issuer only if the beneficiary is entitled to the money; and the issuer, caught in the middle, wants to pay only if the demand for payment is proper. *Id.*

There are also three different contracts involved in the issuance of a LOC: "(1) the business transaction between two parties, [usually the account party and the beneficiary,] represented by the contract between them; (2) the letter of credit, which usually involves a bank as issuer and one of the parties to the business transaction as beneficiary; and (3) the reimbursement agreement between the issuer and the account party." *Id.* These three contracts are separate, distinct, and independent of each other. *Id.*

Article 5 of the *Uniform Commercial Code* (U.C.C.) applies to LOCs. Under this Article, which has been adopted in some form by all the states and the District of Columbia, a LOC is a "definite undertaking. . . by an issuer to a beneficiary at the request for the account of an applicant. . . to honor a documentary presentation by payment or delivery of and item of value." U.C.C. § 5-102(10) (2010). While Article 5 does not require all the normal requisites of a LOC to be included in the undertaking, a LOC must be a record "authenticated by (i) a signature or (ii) in accordance with the agreement of the parties. *Id.* § 5-104. As long as a LOC follows the guidelines in sections 5-102(10) and 5-104, a letter of credit will typically be valid even if it omits one or more of the following: the amount, the expiration date, the place where presentation should be made, and the documents that must be presented to entitle a person to honor. *Id.* § 5-104, comment d.

Furthermore, section 5-103(d) introduces the important concept of "independence that governs LOCs. According to this section, the "[r]ights and obligations of an issuer to a beneficiary or a nominated person under a

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[LOC] are *independent* of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it." The doctrine of independence allows for the drawing of funds regardless of any underlying agreements. The following further discusses this principle and LOCs authorized by U.C.C. Article 5.

Therefore, while it might intuitively appear that the government beneficiary should not be able to draw on the LOCs unless either a subdivision development is contemplated or the subdivision improvements for which the LOC was arguably meant to guarantee would or will in fact be constructed by the government beneficiary if the developer fails to do so, the law on the subject does not appear to so provide. "Letters of credit transactions involve three relationships: that of the bank to its customer who purchases the letter of credit; that of the bank to the beneficiary to whom it makes a promise to pay; and finally, that between the customer and the beneficiary." *In re Onecast Media, Inc.*, 439 F.3d 558, 564 (9th Cir. 2006). "Under the so-called principle of independence, each of those three transactions must be treated separately." *Id.*; *see also* U.C.C. § 5-106(d). Focusing on the relationship between bank and beneficiary, "a letter of credit creates 'an absolute, independent obligation and payment must be made upon presentation of the proper documents regardless of any dispute between [underlying parties.]'" *Warner Bros. Int'l Television Distrib. v. Golden Channels & Co.*, 522 F.3d 1060, 1062 (9th Cir. 2008); *see also, Andy Marine, Inc. v. Zidell, Inc.*, 812 F.2d 534, 536 (9th Cir. 1987) ("[T]he general rule that an issuer's obligation to a beneficiary does not depend upon the fact of default, but upon the presentation of documents as evidence of default."); *H. Ray Baker, Inc. v. Associated Banking Corp.*, 592 F.2d 550, 552-53 (9th Cir. 1979) ("The bank's obligation under the letter of credit is independent of the underlying sales contract. If the presented documents comply with the terms of the letter of credit, the bank is obligated to pay . . . ."); U.C.C. § 5-106.

For example, in *Colorado Nat'l Bank of Denver v. Bd. of Cnty Comm'rs*, 634 P.2d 32, 34 (Colo. 1981), the developer obtained plat approval for several subdivisions relating to the development of a mountain recreation facility. The developer executed a subdivision improvements agreement and instructed the bank to issue three LOCs to secure its obligation under statute and subdivision regulations to construct roads. *Id.* at 34. The three LOCs, totaling approximately $350,000, were equal to the estimated costs of the contemplated infrastructure improvements. *Id.* at 34. The county was authorized to draw directly on the LOCs by fifteen-day sight drafts accompanied by a statement that improvements had not been made. *Id.* at 34.

The developer subsequently went bankrupt. Construction of the roads or related improvements was never commenced, and the county attempted to draw on the LOCs. *Colo. Nat. Bank*, at 34. In litigation that followed the bank's failure to honor the drafts, the bank's primary argument was that "the planned subdivisions remained essentially undeveloped and unpopulated raw mountain properties," and that the county had "neither constructed, made commitments to construct, nor planned to construct the roads or other improvements described in the subdivision improvements agreements secured by the letters of credit." *Id.* at 35. The bank alleged that utilization of the funds for anything other than the contemplated road improvements would result in an "unjustifiable windfall" to the county, and would furthermore be "fraud in the transaction," a recognized exception to the bank's duty to honor the county's demands for payment. *Id.* at 39.

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This argument was rejected at the trial court, court of appeal, and ultimately by the Colorado Supreme Court. The Court affirmed the trial court's decision to deny the bank's request to show that the county would "utilize the funds it would receive in a manner other than that specified in the road improvements agreements" and limit evidence to the LOCs, the county's demands, and the bank's replies to those demands. *Id.* at 36. The Court first explained that "fraud in the transaction" must necessarily stem from "conduct by the beneficiary . . . against the customer of the bank" and "be of such an egregious nature as to vitiate the entire underlying transaction so that the legitimate purposes of the independence of the bank's obligation would no longer be served." *Id.* at 39. The Court noted that no such fraud was evident in the record, nor had any such fraud been alleged. *Id.*

Relying on the independence principle to bar the bank from litigating the underlying transaction, the Court based its analysis on the fact that "the letters of credit, and the Bank's obligations thereunder, are separate and independent from the underlying subdivision improvements agreements between [the developer] and the County." *Id.* at 38. Thus, the bank could not introduce evidence regarding the underlying transaction because it was "irrelevant to the Bank's obligations under the letter of credit." *Id.* The Court pointed out that if the bank had wanted to condition payment on actual construction of the roads, "it could have incorporated such a condition in the letters of credit." *Id.* It would therefore logically follow, and the Court noted, that a bank is unable to "challenge the utilization of funds paid under a letter of credit." *Id.* at 39. Although the Court ultimately found that some of the LOCs were rightfully dishonored by the bank, that decision was based solely on the county's failure to strictly comply with the terms of the LOC by presenting an incorrect instrument in attempting to draw down the LOC. *Id.* at 40-42.

This case also represents the views of commentators on the subject. Since the LOC is primarily an agreement between a financial institution and a beneficiary entitled to draw down the funds under specific circumstances, bankruptcy of the developer (the account party) does not affect the beneficiary's rights to the proceeds of the LOC. Payment affects only the issuer's assets and not that of the foreclosed developer "although the payment on the credit gives rise to an immediate claim by the issuer for reimbursement from the account party." Michael Shultz & Richard Kelly, *'…Or Other Adequate Security': Using, Structuring, and Managing the Standby Letter of Credit to Ensure the Completion of Subdivision Improvements*, 19 Urb. Law. 39, 52-54 (1987).

However, the California Court of Appeals has held contrary to *Colorado National Bank* in *County of Yuba v. Central Valley National Bank.* 97 Cal. Rptr. 369 (Ct. App. 1971); James A. Kushner, 2 Subdivision Law & Growth Mgmt. § 9:20, n.2. In *County of Yuba*, the developer purchased unimproved agricultural land planning on constructing single-family residences for personnel of a near by military base. *Id.* at 370. The county agreed to approve the final map conditioned on the developer "complet[ing] required improvement work upon streets and drainage facilities within 12 months." *Id.* The developer instructed the bank to execute an "instrument of credit" for approximately $35,000 to secure performance. *Id.* The military base subsequently reduced its number of personnel, and construction ceased. *Id.* at 370-71. The issue on appeal was "whether [the] Bank remains liable to [the] County in the absence of commencement of any development [of the given tract] or any construction of the improvements therein." *Id.* at 371.

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The Court held that the bank was not liable because the "performance [that the instrument of credit] secured related to improvement work which would at least have commenced." *Id.* This holding can be distinguished from the Colorado case on two grounds. First of all, the instrument of credit contained specific and explicit language so that the "guarantee" was being "pledged to meet the performance of completed street improvements." *Id.* This is in contrast to the broader language of the usual standby LOC, with no explicit reference to the type of infrastructure improvements that the letter of credit was securing. Perhaps even more importantly, *County of Yuba* involved an "instrument of credit" rather than a LOC. The court explicitly looked to the "underlying contract" which "demonstrate[d] that the sole basis for the relationship between [the parties] was the development of [the land] as a residential subdivision." *Id.* at 372. This is in contrast to how courts construe LOCs, relying heavily on the independence principle to decline to examine the underlying transaction.

Transfer of Funds

Within limits (as, for example, state procurement requirements including, for some purposes, notice and bidding), a local government can transfer funds to whomever it wishes so long as such transfer is either (a) for a public purpose or (b) in exchange for, or as payment for, property to be acquired by the governmental body or (c) in accordance with a court order. Indeed, many LOCs provide for such a potential transfer on the face of the LOCs themselves.

Assuming that the government beneficiary has the right to draw down the LOCs, the beneficiary need only strictly comply with the terms of the LOC. If the beneficiary does so, the issuer has an "absolute obligation to honor the draft." Richard Kelley & Michael M. Shultz, *'… Or other Adequate Security': Using, Structuring, and Managing the Standby Letter of Credit to Ensure the Completion of Subdivision Improvements*, 19 Urb. Law. 39, 56 (1987). Although one might intuitively conclude that a failed developer's successor in interest is entitled to some of the funds, the law is actually to the contrary because the three contracts involved in a letter of credit transaction are "separate, distinct, and independent of each other." Steiner, *supra* at 133. If any party is entitled under applicable case law and secondary source analysis to return of the funds drawn by the government beneficiary under the terms of the LOCs on the ground the funds are neither needed or to be used for the relevant subdivision improvements, it is the issuing bank. To the extent existing collateral provided by the failed developer of the project covers the payout to the beneficiary under the LOCs, the issuer has little, if any, basis to make such a claim, of course. The independence principle is in fact so strong that "[a]n issuer must comply with its obligations under the letter of credit without regard to whether it will be reimbursed." Jonathan J. Dunn et al, *Letters of Credit in Construction Projects*, 29 Construction Law 33, 36 (2009).

On the other hand, a few cases have held that "the doctrine of independence protects only the *distribution* of the proceeds of the letter of credit." *Two Trees v. Builders Transp., Inc. (In re Builders Transp., Inc.)*, 471 F.3d 1178, 1186 (11th Cir. 2006). In *Resolution Trust Corp. v. United Trust Fund*, 57 F.3d 1025, 1034 (11th Cir. 1995), the court determined that the issue was the right to the proceeds of the LOC, not "the right to draw on the letter." The court deemed the LOC drawdown proper, but that "[o]nce the proceeds of a letter of credit have been drawn down, the underlying contracts become pertinent in determining which parties have a right to those proceeds." *Id*. "In other

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words, an irrevocable standby letter of credit does not nullify the obligations set forth in the underlying contracts." *Id*. at 1034-35. Because the challenge was not to the distribution of the LOC proceeds, but to the *retention* of the proceeds pursuant to the underlying contract, the court held the doctrine of independence to be inapplicable.

Furthermore, in one jurisdiction where a covenant of good faith and fair dealing is implied in every contract, a court held that there was a "duty to return the excess proceeds drawn down from the standby letter of credit that were not used to secure [one's] obligations" in the absence of any provision to the contrary. *Two Trees*, 471 F.3d at 1187. Bankruptcy courts have held similarly: "[T]o the extent a letter of credit is drawn down in an amount in excess of that which the beneficiary of the letter of credit is legally entitled to receive, case law permits the recovery of those *wrongfully* drawn funds from the beneficiary." *Litzler v. Chamblee & Ryan, P. C. (In re TIC United Corp.)*, 2008 Bankr. LEXIS 2040, 2008 WL 2437868, at *6 (Bankr. N.D. Tex. June 17, 2008) (emphasis in original). However, the issuing bank, other things being equal, appears to be entitled to the drawn-down funds, and not a 3rd party successor to the rights of the failed developer.

In sum, there appears to be sufficient authority to warrant the drawing down of funds from LOCs by state and local governments, so long as the procedures for doing so, as set out in the LOCs, are strictly followed. Indeed, it is likely that the government beneficiary, and only the government beneficiary, can draw down these funds. While authority appears to conclude that government beneficiaries may draw down the funds from LOCs, other case law has held that the underlying contracts become pertinent in determining which parties have the ultimate right to those funds after the LOC drawdown. In other words, a standby LOC does not necessarily nullify the obligations in the underlying contracts, but only shifts the burden of litigation from the government as the LOC beneficiary to the account party or its successor-in-interest. An issuing bank is most likely to have such rights against the government beneficiary as payee. To the extent that a bank is reimbursed for the funds paid to the government beneficiary under the LOC because of collateral the bank may have received from a failed developer, the bank may, of course, fail to seek return of funds from the government beneficiary.

III. Performance Bonds

A performance bond is also a tripartite agreement, between a contractor, a surety, and an owner. Restatement (Third) of Suretyship and Guaranty ("Restatement") § 1 (2009). The surety acts as a secondary obligor insuring the contractor's performance of the construction contract to the owner. Brunner & O'Conner on Construction Law § 12:2 (2010). The contractor is thus the primary obligor to the owner based on the underlying construction contract, and the owner becomes the obligee under the performance bond. *Id.* The Restatement explains the relationship created by a performance bond as follows:

[I]t is common to have the suretyship relationship created by a "surety bond." Typically in such a case, the principal obligor [the contractor] alone has a separate duty to the obligee [the owner or "upstream contractor" under a performance bond], and the principal obligor and the secondary obligor [the surety] both execute a "bond" [the contract of suretyship] pursuant to which they each agree to be liable (often, up to a stated limit) in the event of the default of the principal obligor as to the separate duty [contract performance and

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payment]. In that case, the obligation of the secondary obligor on the surety bond is the secondary obligation, while the obligations of the principal obligor on the surety bond and on the separate duty together constitute the underlying obligation. Thus, while the principal obligor is liable on the same contract that creates the secondary obligation, the principal obligor's duty arising from its status as a party to the contract is part of the underlying obligation.

Restatement § 1, comment d.

A surety's obligation under a performance bond is conditional and is usually triggered upon:

1. The obligee's substantial performance of its obligations under the bonded contract;
2. The principal obligor's material breach of the bonded contract sufficient to warrant termination; and
3. The obligee's proper notice to the principal obligor and surety of the material breach and termination of the bonded contract.

Bruner & O'Conner on Construction Law § 12:13. If the bonded contract is performed in conformance with its terms and conditions, the surety's obligation never arises, and the bond becomes null and void. *Id.* § 12:14. This is a key distinction between LOCs and performance bonds. LOCs are agreements by a bank or other issuer to pay a certain amount of money upon the presentation of the specified documents. Casius Pealer, *The Use of Standby Letters of Credit in Public and Affordable Housing Projects*, 15 J. Affordable Housing & Community Dev. L. 276, 277 (2006). The standby LOC is guided by the principle of independence. *Id.* Payment of the LOC only requires presentment of the proper documents. Obligations under performance bonds, on the other hand, depend on the underlying contract. Id. Since the purpose of a performance bond is to secure the performance of the construction contract, the bond and the contract must be construed together. *U.S. v. Phoenix Indem. Co.*, 231 F.2d 573 (4th Cir. 1956). Accordingly, the surety's obligation upon default is defined by the underlying contract, *S. Sur. Co. v. City of Prescott*, 221 P. 834 (Ariz. 1984), and the surety's obligation is co-extensive to that of the principal obligor under the contract. *Pac. Coast Eng'g Co. v. Detroit Fid. & Sur. Co.*, 5 P.2d 888 (Cal. 1931). Furthermore, a surety's obligation under the performance bond will not arise until there is a breach or non-performance of the underlying contract. Determining a default of the construction contract is a difficult task. "Default" has been understood by the courts to mean a material breach of the bonded contract that would warrant termination. *L & A Contracting Co. v. S. Concrete Serv., Inc.*, 17 F.3d 106, 110 (5th Cir. 1994). "Not every breach of a construction contract constitutes default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of breaches (2) of such magnitude that the obligee is justified in terminating the contract." *Id.*; *see also St. Paul Fire & Marine Ins. Co. v. City of Green River*, 93 F. Supp. 2d 1170 (D. Wyo. 2000).

When the obligee determines that the principal obligor has materially breached the construction contract, the obligee must give "notice of default" prior to termination of the contract. Bruner & O'Conner on Construction Law § 12:42. While many contracts incorporate notice provisions, the right to notice has been held so fundamental that even in the absence of such provisions, the obligee is required to give fair notice and a reasonable opportunity to correct deficiencies or non-conformances before

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the obligee terminates the contract. *McClain v. Kimbrough Const. Co.*, 806 S.W.2d 194, 198 (Tenn. Ct. App. 1990); *Pollard v. Saxe & Yolles Dev. Co.*, 525 P.2d 88, 92 (Cal. 1974). This notice must "fairly apprise the contractor and the surety of the specific details which the obligee regards as sufficiently material to future contract performance to warrant termination of the contract if the defaults are not cured." Bruner & O'Conner on Construction Law § 12:42; *see also L & A Contracting Co.*,17 F.3d at 111 n. 18; *Belfour Beatty Const., Inc. v. Colonial Oriental Iron Works, Inc.*, 986 F. supp. 82, 86 (D. Conn. 1997). The notice must "describe the inadequate performance and must fairly advise [the contractor] that [the owner] considers the inadequate performance serious enough that, without prompt correction, the contract will be terminated." *Blaine Econ. Dev. Auth. V. Royal Elec. Co.*, 520 N.W.2d 473 (Minn. Ct. App. 1994).

After notice of default, the surety may conduct an investigation to determine if there was in fact a default by the principal obligor. This investigation must be completed with "reasonable promptness." *Metro Wastewater Reclamation Dist. v. Alfa Laval, Inc.*, 2007 WL 460851 (D. Colo. 2007). When there is in fact a default under the contract, the surety's obligation arises. There are a variety of different ways a surety may remedy the default including:

1. Finance the contractor to complete the project;
2. Takeover the completion of the contract;
3. Tender money to the obligee to hire a new contractor who may then enter into a completion contract with the obligee;
4. "Buy back" the bond through a cash settlement with the obligee; or
5. Deny default or assert contract and bond defenses and "do nothing."

Surety's Financing of the Contractor to complete the project:

Because the contractor will most likely attribute default to a temporary cash flow shortage, the surety may decide to finance the contractor allowing the contractor to finish the contract according to its terms. However, the surety must determine whether an inflow of cash will be sufficient to cure the default. The surety may decide to finance the contractor where the obligee has no complaints about the contractor's quality of work, the project is almost finished, and the default was caused by a delay due to temporary cash flow problems. Bruner & O'Conner on Construction § 12:79. But this financing option can be dangerous because surety companies are not always experienced in commercial lending. *Id.* Furthermore, contractors that have already exhausted all lines of credit and have no assets to support a loan may become a "bottomless financial sinkhole." *Id.* A decision to finance the contractor should be entered into cautiously, carefully weighing the potential costs against the amount of work that needs to be done to cure the default. *Id.*

Surety's takeover and completion of the project:

Obligees usually desire the surety to take over the completion of the project, especially where the obligee does not have much construction management experience. *The Sch. Bd. of Broward Cnty. v. The Great American Ins. Co.*, 807 So.2d 750 (Fl. Dist. Ct. App. 2002). This option is also beneficial as it allows the surety to have more direct control over the completion of the project. Bruner & O'Conner on Construction Law § 12:80. However, taking over such a project may open the surety to even higher levels of liability. If the surety promises to complete the project, the surety waives the bond limit and must complete the project regardless of the cost unless the obligee agrees

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to cap costs at the bond limit in the takeover agreement. *Id.* Under the option to takeover, the takeover agreement becomes a critical document. This agreement offers the surety a "more definitive representation and understating with the owner and its inspecting architect regarding the adequacy of work completed and identification of work in need of remediation." *Id.* This agreement can over-ride the underlying contract in order to provide a workable schedule and commitment to complete the project. *Concra v. Int'l Fid. Ins. Co.*, 860 F. Supp. 13 (N.D. N.Y. 1994).

Once this takeover agreement is negotiated, the surety will enter into a completion contract with a contractor. The surety may decide to award the contract to its defaulting contractor, but is under no obligation to do so. *N.V. Heathorn, Inc. v. U.S. Fid. and Guar. Co.*, 2007 WL 141174 (Cal. App. 1st Dist. 2007). Unless the bond specifically allows the obligee to select a completion contractor, the obligee may not interfere with the surety's contractor selection. *St. Paul Fire & Marine Ins. Co. v. City of Green River*, 6 Fed. Appx. 828 (10th Cir. 2001). However, the completion contract must be consistent with the takeover agreement. Bruner & O'Conner on Construction Law § 12:80.

Surety's tender of completing contractor:

The option for performance most favorable to the surety is the tender of an acceptable completion contractor with whom the obligee may enter into a completion contract guaranteed by another surety. *Id.* § 12:81. When the obligee accepts the tender of a new contractor, the surety must pay the amount by which the new contract exceeds the funds remaining under the original contract. *Id.* This option relieves the surety from all further liability under its performance bond. *Scott v. Red River Waterway Comm'n,* 926 So.2d 830 (La. Ct. App. 2d Cir. 2006). By exercising this option rather than the takeover option, the surety removes itself from the process upon tender, saving them oversight and management expenses. Bruner & O'Conner on Construction Law § 12:81. As long as the scope of the completion contract covers all unfinished work, the surety's obligation to perform will be completed upon acceptance of the tender by the obligee. *Id.*

Surety's "buy back of the bond":

Where an obligee wishes to control reletting the unfinished work, the obligee may "buy back" the bond. Under this option, the obligee and surety enter into an agreement that allows the surety to pay an agreed upon amount which is less than the full bond amount. "Because the 'buy back' is in lieu of the surety's other completion options, and because both parties must agree upon the amount of the buy back, the waiver of the surety's right to perform and the obligee's right to require performance is consensual." *Id.* § 12:82.

Surety's option to "do nothing":

Where a surety, after investigation of alleged default, finds that the obligee has wrongfully defaulted the original contractor, or there is a discharge of the surety's obligation under contract or bond defenses, the surety may choose to "do nothing." *Id.* § 12:83. While the surety may avoid the immediate cost of completing the contract under this option, an incorrect assessment of the surety's obligation can lead to increased liability. *Id.* If the surety incorrectly decides to "do nothing", the surety may be subject to "punitive damages for breach of the implied covenant of good faith and fair dealing owed to the obligee." *Id.*; *see also Nat'l Fire Ins. Co. of Hartford v. Fortune Const. Co.*, 320 F.3d 1260 (11th Cir. 2003); *Transamerica*

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Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348 (Colo. 1997). Accordingly, sureties should only decide to "do nothing" when the right to do so is clear. In close cases, the surety should perform under the bond and preserve its defenses. Bruner & O'Conner on Construction Law § 12:83.

IV. Conclusion

The Standby Letter of Credit (LOC) provides government an excellent alternative to the more traditional use of the performance bond to guarantee developer provision of required or bargained-for public facilities and other infrastructure. Drawing it down requires only compliance with the terms on the face of the LOC, which terms are primarily procedural. Other potential or actual claims on the face amounts of the LOC are largely irrelevant, and only the government beneficiary is entitled to draw-down. For both developer and government, the historical use of the LOC in other commercial transactions together with protections from the Uniform Commercial Code insulates it from a variety of collateral claims, increasing the ready availability of funds for infrastructure completion. Courts are simply unwilling to adversely affect the utility and use of the LOC and its historical commercial paper status. On the other hand, the more traditional performance bond is more likely to guarantee the funds are drawn down only for the purpose of completing such infrastructure, and are likely subject to collateral attack by parties who may now stand in the shoes of a defaulting account party/developer raising various objections to the pay-out by the bond guarantor. Finally, whether LOC or performance bond, once the funds are drawn down it is possible for other parties to contest the ultimate use of the funds. While this possibility occasionally results in reluctance of local government to draw down LOC's due to uncertainty over their eventual use and over possible additional claimants, best practice appears to dictate that the funds be drawn down before the LOC "expiration" date and placed in escrow pending final settlement of use and additional claims. ■

Meetings Calendar

2011 Mid-Year Meeting
March 17-20, 2011
Loew's Ventana Canyon
Tucson, AZ

2011 Annual Meeting
October 20-23, 2011
The Westin Philadelphia
Philadelphia, PA

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

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