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Commercial Real Property Receiverships – Current Questions and Comments

By: Gregg Davis, Mark Weibel and Steve Schoettmer

Thompson & Knight, LLC.

INTRODUCTION

Commercial real property receiverships have received tremendous interest, discussion and comment in the current economic cycle.

The Fall '11 issue of Commercial Insight featured "Public and Private Sales of Real Property by Federal Court Receivers," by John C. Murray and Kenneth R. Jannen of First American Title. That article provides a very good background and overview of several advantages and reasons to use receivers to resolve distressed or defaulted loans, focusing on federal court receivers and defaulted commercial mortgage-backed securities ("CMBS") loans. It also set out the jurisdictional and statutory basis, and example forms, for appointment of a federal receiver and sale of property.

This article will focus on a few current topics and recurring themes from recent workouts and litigation involving receivership appointments, to illustrate some of the advantages of and reasons to use receivers. To provide a variety of perspectives, Mark Weibel, Steve Schoettmer, and Gregg Davis discuss and respond to frequently asked questions, based on their experiences in cases involving commercial real property receivers.

Gregg Davis

Mark Weibel

Steve Schoettmer

Question 1: Lenders sometimes move very quickly to seek receivers. Why is that?

MW. Often, to get control of the cash flow – cash is the most important issue -- and to get the management of the property out of the hands of the borrower as soon as possible. That's especially important if the lender is concerned that the borrower may be withholding or misappropriating cash flow from the property.

SS. If the borrower files bankruptcy after a receiver is appointed, the cash collateral will usually continue to be collected by the receiver, rather than being controlled by the borrower. If a receiver is not in place when bankruptcy is filed, the lender can certainly seek a cash collateral order to limit the borrower's use of cash, but the lender is in a much stronger position if the cash belongs to the receiver rather than the borrower, before the bankruptcy is filed.

As the lender's trial lawyer, I also want to stop a borrower from using the lender's

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cash collateral to pay borrower's counsel to try to hang on to property after a default.

GD. If a hard lockbox is in place to capture cash flow, or if the borrower is cooperating with the lender and providing timely and detailed cash flow reports showing the cash flow is not leaking or being misappropriated, then the need for a receiver becomes less immediate. But there are still other, longer term advantages of a receiver.

Question 2: What are some other advantages of a receiver?

GD. A sale of the property with a CMBS loan modification and assumption can generate huge value for the lender, that otherwise would be lost. If a defaulted CMBS loan is foreclosed, the lender incurs a "locked in" loss that cannot be reduced through a new loan or seller financing when the lender re-sells the foreclosed property. But if there is a receiver the locked in loss can be deferred or avoided. Subject to court approval, the lender and receiver can work together to simultaneously close a receiver's sale of the property to a new owner, and a modification of the defaulted loan, resulting in the new owner assuming a modified loan and the lender obtaining a significantly greater recovery than if the lender foreclosed. We'll discuss an example of that later, on an Arizona property.

MW. Also, it is easier for the lender to trust the project revenue figures because they are prepared by the receiver as an independent third party, rather than the borrower.

Question 3: Are certain types of property more suited to receiverships than others?

GD. Generally, the more day to day operation is required at a property, the more appropriate a receiver will be. Hotels often make good receiver candidates. Guests arrive and depart daily, and restaurants and liquor sales and licenses require specialized attention. Often, the hotel's franchise agreement with its franchisor (the "flag" or brand) is in default. The borrower's failure to perform deferred maintenance to keep the condition of the hotel up to the flag standard is a common problem, and can give the franchisor a right to leave the property. Everyone, particularly the lender if the loan is nonrecourse, has a real problem if the hotel is left without a "flag" to market and accept reservations for the property. A receiver is in a position to negotiate with the franchisor to keep the flag in place while a new purchaser is identified and, if necessary, while interim improvements are made. Even if a flag change is ultimately required, a receiver often is in a better position than the borrower and the lender to at least keep the existing flag in place on a temporary basis, until new ownership and a new franchisor can be identified.

Question 4: Are receiver appointments usually contested?

SS. I hate to say it, but "it depends" really is the answer. In my experience, there usually is not a serious disagreement over whether a default has occurred and the lender is entitled to a receiver under the loan documents. In the rare cases where those truly are open questions, then the receiver's appointment is likely to be contested, the parties will have a chance to argue, and the court will decide whether to appoint a receiver. But in many situations, the borrower and lender are able to negotiate an agreed receivership.

Some borrowers will contest a receivership in order to try to gain a negotiating advantage. However, CMBS loans often provide for full recourse liability of the guarantor if the borrower opposes the lender's request for a remedy (like appointment of a receiver) that is set out in the loan documents. In those situations, or if the borrower knows it is in default and wants to limit the battles it fights with the lender, an agreed receivership can be negotiated.

Question 5: Are receivers ever appointed over the objection of a borrower? If so, are properties ever sold over the objection of a borrower?

MW. Although we like to gain the borrower's cooperation by explaining the benefits to everyone (including the borrower) if a receiver is controlling the property, a receiver can be appointed over a borrower's objection. We had a case like that in Arizona. The outstanding debt on a portfolio of seven (7) multifamily properties was about $164 million. Everyone agreed that the property was worth less than the debt, so the borrower had no equity in the property. The guarantor, who later took control of the borrower, was essentially trying to force the lender to modify and reinstate the loan with a reduced principal balance of $82 million. That 50% write-down would have locked in a loss of more than $82 million for the CMBS lender. At the outset, the borrower simply stopped operating the project, leaving no management in place and causing numerous mechanics liens to begin getting recorded against the project. Although securing a receiver in Arizona is unique, we argued that, not only was a receiver appropriate, the receiver was necessary for several reasons. A receiver could address immediate life-safety issues (like payment of utilities), provide a way for the lender to stabilize the property without incurring lender liability risk, and act as a third party reporting on the current condition and cash flow of the project. Ultimately, the court agreed to appoint a receiver. We thought that was the right decision all along, but Steve can pick up the story from there.

SS. Property can be sold by a receiver, even if a borrower objects. In the Arizona case Mark mentioned, the receiver was able to work with the lender, obtain multiple offers for the property, and ultimately identify a purchaser willing to purchase the property for $133 million, which was about $50 million more than the borrower was willing to offer. And the purchaser's offer included $10 million of new cash equity, which would not have been available if the borrower retained ownership of the property. Because of all those advantages, the lender was willing to restructure the loan to fit the new purchaser's plans to reposition and hold the property, to give values an opportunity to recover, and put everyone in a much better position than if the borrower retained ownership or if the lender simply foreclosed.

Underwriting Mechanics' Lien Coverage in the New Economy:

By S.H. Spencer Compton and Steven G. Rogers

In 2008, came the subprime mortgage loan crisis, the Lehman Brothers Chapter 11 bankruptcy filing and the financial meltdown. Numerous borrowers defaulted on commercial real estate financings, leaving many failed construction projects in their wake. As a result, title insurers have reevaluated the manner in which they underwrite mechanics' lien risk.

This article will discuss current approaches to underwriting inchoate mechanics' liens. An inchoate mechanic's lien is one that has not yet been filed, but once it is filed, its priority date relates back in time to the date upon which the work performed or materials furnished first commenced.

An existing mechanics' lien claim is illustrative of the kinds of tactics being employed today by certain indemnitors to evade their contractual liability.

A mixed use project consisting of three towers closed in April of 2007. The cost of construction was to be $124 million dollars, comprised of a $97 million dollar loan secured by an insured mortgage and $27 million dollars of borrower's equity. Since construction had already started, the "broken priority" of the mortgage to be insured was a concern. "Broken Priority" means that any inchoate liens could prime (i.e. gain priority over) the lien of the mortgage securing the construction loan.

A title insurance company's underwriters reviewed the borrower's financial information and took an indemnity from the local developer (now in bankruptcy) and its principal, Mr. X, individually. Mr. X is a businessman who owns a large company. At closing, he

S.H. Spencer Compton

Steven Rogers

had a purported net worth of $750 million dollars. Mr. X also gave the mortgage lender a personal guaranty on the loan for $44 million dollars. (As of this writing, the lender has already obtained a judgment against Mr. X for $40 million)- Guess where this is going….

In July, 2008, due to cost overruns and a market decline (no condo sales), construction stops. The first tower is complete. The second tower is framed with 2/3 of its outside skin in place and the third tower is excavated only. $25 million dollars in mechanics' liens are promptly filed.

To date, the title insurer has spent $2 million in defense costs and will end up paying millions of dollars more to settle all of the claims.

The insurer is now suing Mr. X to honor his indemnity. He contends that 1) all of his assets are community property under state law and, since his wife did not sign the indemnity, the assets can't be executed on, and 2) the indemnity may be invalid or void because the title insurer owed him a duty to disclose that there were liens or potential liens against the project at the time of closing (there were notices of commencement but no actual liens recorded) and that the insurer should have obtained subordination agreements from these potential lien claimants prior to closing.

The title insurance company has since discovered that the cost to construct may have been artificially low due to side profit sharing agreements with some of the subcontractors where the subs agreed to discount the amount they would charge for their work in exchange for which they would be repaid the discount plus an additional payment upon completion of the project.

The title insurer has a hearing scheduled to amend its complaint against Mr. X to include fraud/ misrepresentation. Adding insult to injury, one of the largest liens against the project belongs to a company owned and/or controlled by Mr. X.

In light of such unsatisfactory indemnity experiences, how are title insurance companies modifying their underwriting practices to address today's increased inchoate mechanic's lien risk?

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Nationwide, there are essentially three different types of statutory schemes governing the attachment and establishment of the priority of mechanics' and construction liens:

1) priority established by the date on which materials or labor are first provided (or the commencement date), so long as an inchoate lien is filed or recorded ("Type 1") ;
2) priority established by the date of filing of a notice of commencement or the lien itself("Type 2") ; or
3) priority established by the initiation of judicial action ("Type 3").

The majority of jurisdictions, including New York, fall within scheme Type 1. In these States, upon the commencement of the furnishing of materials or performance of labor, as set forth in the particular statute, the mechanics' or construction lien is inchoate until the filing or recording of the notice of lien in the manner prescribed by statute.

Once perfected, the lien in these states attaches as of the date of the commencement, though not so in New York due to the lien clause required by Section 13 of New York's lien law. In New York, a lienor has a period of eight months following the completion of the improvements or furnishing of materials (four months if a single family residential property) in which to file their notice of lien. Any conveyance instrument filed subsequent to the commencement of the improvement would be subject to the validly filed notice of lien unless it contains a covenant similar to the following:

AND the party of the first part, in compliance with Section 13 of the Lien Law, covenants that the party of the first part will receive the consideration for this conveyance and will hold the right to receive such consideration as a trust fund to be applied first for the purpose of paying the cost of the improvement and will apply the same first to the payment of the cost of the improvement before using any part of the total of the same for any other purpose.

Alternatively, a statement as simple as, "subject to the trust fund provisions of section thirteen of the lien law" may be used.

The party taking delivery of the instrument containing this covenant can rely upon the record in determining the status of title and those matters that affect it. They are not vulnerable to an inchoate lien being filed following the conveyance which springs into priority ahead of the interest conveyed to them. It adds an element of predictability for the purchaser not found in the other States that make use of scheme Type 1.

As a result of the Lien Law § 13(5) trust fund, the underwriting practices of title insurers of New York property in connection with inchoate mechanics' liens are somewhat different from those of title underwriters of property located in other States. So long as the instruments of conveyance contain the lien clause, inchoate mechanics' liens need not be addressed since the purchaser and/or lender will be conveyed their interests free of the same for the reasons set forth above.

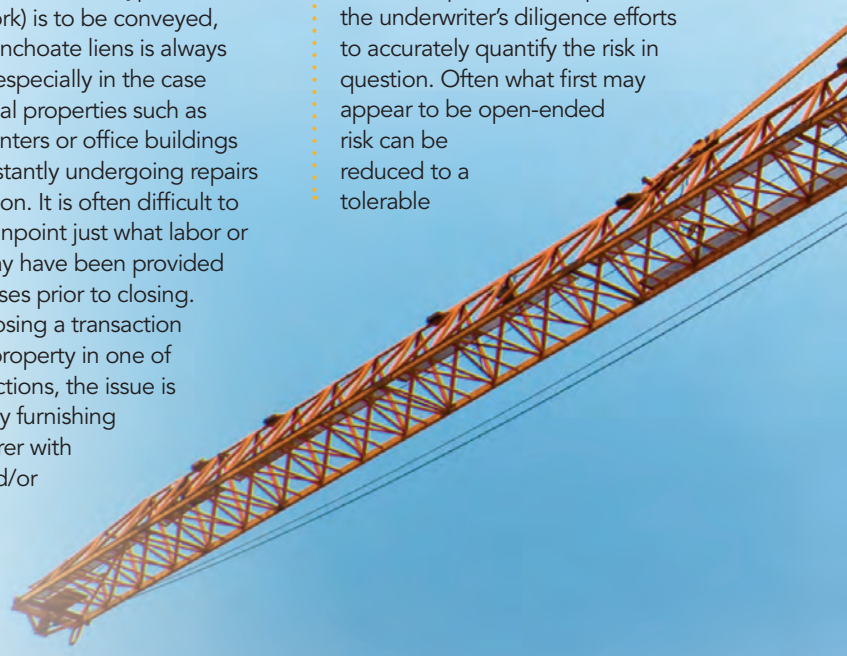
Generally, the only mechanics' liens of concern are those duly filed in the county clerk's office that should be disclosed during a search of the clerk's records. Nor are inchoate liens a concern in those States that follow scheme Types 2 or 3. This is not the case, however, in the majority of jurisdictions.

When real property located in any States with scheme Type 1 (other than New York) is to be conveyed, the issue of inchoate liens is always of concern, especially in the case of commercial properties such as shopping centers or office buildings that are constantly undergoing repairs and renovation. It is often difficult to accurately pinpoint just what labor or materials may have been provided to the premises prior to closing.

When closing a transaction involving a property in one of these jurisdictions, the issue is addressed by furnishing the title insurer with affidavits and/or indemnities. The owner of the premises will generally provide an affidavit which states that the improvements on the real estate were completed, and that no new construction or major repair work has been performed thereon for at least the period within which the inchoate lien could be filed in the particular jurisdiction.

Further, the affidavit will state that the owner of the premises has not contracted for any labor or materials to be furnished that might become the subject of a lien or that such labor or materials, if furnished, has been paid for in full. If the owner cannot make those representations, then an indemnity in favor of the title insurer will be necessary in order for a title insurance policy to be issued without raising an exception to coverage with regard to inchoate liens which may take priority over the interest insured.

What other approaches are title insurance underwriters taking to get comfortable with inchoate mechanics' lien risks today? To the extent such a risk is a quantifiable dollar amount, an escrow account funded with some multiple of that amount may be required. Alternatively a bond or a letter of credit could be posted. Given the prohibitive cost of any of these solutions, a borrower's initial approach to the underwriter's concerns should be proactive cooperation with the underwriter's diligence efforts to accurately quantify the risk in question. Often what first may appear to be open-ended risk can be reduced to a tolerable



contingency by a thorough and transparent presentation of the facts. Additionally, title insurers routinely are declining to insure mechanics' lien risks arising after the date of the title insurance policy by only issuing the FA 61 endorsement, which provides affirmative coverage against mechanics liens only up to the date of the policy.

Just as lenders reeling from their losses today have adopted more conservative lending standards, so title insurers are more cautious in light of recent history.

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"Type 1" States: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin

"Type 2" States: Florida, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, Nebraska, New Jersey, Rhode Island, South Carolina

"Type 3" States: Maryland, New Hampshire

Lien Law § 10

Lien Law §13(5)

Standard N.Y.B.T.U. Form 8002

Lien Law §13(5)

A Practical Guide to Securing Surface Rights For Solar Energy Projects

Julie Baird, National Underwriting Counsel for First American Title Insurance Company, National Commercial Services, and Basil ("Bill") Shiber, Shareholder, Miller Starr Regalia, Walnut Creek, California.

Any analysis of the feasibility of a large solar energy project requires that consideration be given to subsurface mineral rights as well as related surface entry rights. Land considered for these projects often includes areas in which oil, gas and mineral deposits exist, and in some cases, where exploration has or is occurring. Solar projects, as opposed to other alternative energy projects, are somewhat unique because they involve extensive coverage of the surface of the ground with photovoltaic panels or other array technology and, given the significant cost of that equipment, it is crucial that developers secure the ability to use the maximum amount of the surface area without interference. This requires the limitation, restriction and/or removal of third-party surface rights to ensure that the technology placed on the surface can operate unimpeded. This article will provide an overview of mechanisms available for that purpose in California and an analysis of the various approaches from a title insurance perspective.

I. NATURE OF MINERAL RIGHTS.

When evaluating prospective project areas for solar development, it may be important to know what types of minerals exist on the site. From a title insurance perspective, it will also be important to know what type of minerals have or have not been severed from the surface rights.

A. Severance.

Generally speaking, the proprietor of the land owns all things below the surface of the land including the minerals. When the property is

Julie Baird

Bill Shiber

conveyed, all of those "things" beneath the surface, including mineral rights, are also conveyed if there is no specific mention in the deed. However, real property may be divided horizontally, just as it can be divided vertically. In other words, it is possible to sever the ownership of the subsurface rights from the ownership of the surface rights. Once there has been a severance, conveyance of the surface does not necessarily transfer title to the subsurface. Rather, each must be transferred separately.

II. SURFACE ENTRY RIGHTS APPURTENANT TO MINERAL RIGHTS.

Ownership of a subsurface mineral interest may include the ability to access the surface of the property in order to extract the minerals. The extent of a mineral holder's surface rights depends on the instrument creating those rights – generally, the reservation in a deed conveying the property, or the separate grant of those rights. The language of the instrument creating the mineral rights (or absence of language regarding surface rights) generally determines the nature and extent of the surface rights created, as set forth below. The nature and extent of the rights will then determine the type of documentation necessary to extinguish or waive the right and subsequently to obtain the desired title insurance.

A. Silence Equals Reasonable Access.

First, the reservation or grant of mineral rights may be silent on the mineral holder's surface rights. In this case, the law generally implies a reasonable right to use the surface to extract the minerals. That is, the mineral rights holder may use the surface of the property in such a manner as is reasonably required for the enjoyment and exercise of the mineral interests, even if he or she has no express right to use the surface. In practice, this generally means the mineral rights holder has the right to enter the surface of land and to extract the minerals, but the

use cannot unreasonably interfere with the surface owner's use of the surface. The extent of surface use allowed will depend on the specific situation; for example: What is the surface currently used for; what is built on the surface; how practical and feasible is access to the minerals from areas of the surface which are not developed or used; is there access to the minerals from any other property; and, what types of mining activity is customary in the area.

B. Instrument Expressly Describes Surface Rights.

Second, the reservation or grant may expressly reference the extent of surface rights conveyed to the mineral rights holder. That express reference may include a specific location on the surface from which the holder may access the minerals or the depth to which the right holder may drill or mine. On the other hand, the access may be broad and include access to any part of the surface of the property or any part of the surface on which no permanent structures exist.

C Instrument Expressly Excludes Surface Rights.

Third, mineral rights may be reserved or granted, but the reservation or grant expressly excludes any rights to access the surface to extract the minerals. In this case, the intent may be that the minerals be accessed only by "horizontal" or "slant" drilling from adjoining property or some other mechanism which does not disturb or intrude on the surface of the property. Often, such a grant will include a specification that the mineral rights granted are a certain number of feet (typically 500 feet or more) below the surface of the property.

III. IDENTIFYING MINERAL INTERESTS.

The first step in any mineral rights analysis is to perform a title review to identify any documentation creating or reserving mineral rights, especially as pertains to surface rights access. At the onset of the transaction or development project, a Preliminary Report should be obtained from a title insurance company reflecting the conditions on which the title insurance company is willing to issue title insurance and specifically, the exceptions to coverage identified by the title insurance company relative to the specific property. Typically, if there is a severance of the mineral rights, the severance would be reflected in this report.

If it is determined that a severance exists, developers can obtain a separate report specific to those mineral rights disclosing the exact nature and detailed ownership interests relating to those rights. Title companies will likely require this type of report from a reliable third party company before they will underwrite insurance based on documentation indicating a waiver or relinquishment of any surface rights. They will want assurance that all of the interests and owners have been identified and that all of the owners have agreed to the documentation limiting or extinguishing their rights.

IV. MECHANISMS FOR LIMITATION OR REMOVAL OF SURFACE RIGHTS.

If a solar project developer discovers that a potential project site has a mineral severance, it will want assurance that any existing mineral rights will not be exercised in a manner that would damage the existing improvements or any future improvements that the surface owner wants to construct. There are several mechanisms to limit or remove surface access rights which can be used to protect a proposed solar energy project from interference.

A. Negotiation.

The first mechanism is an old fashioned one – negotiation with the holder of the rights to limit or eliminate any surface access. One of the biggest challenges with respect to the negotiation option is locating the holder of the mineral rights. It may be that there are numerous holders of the rights because the interests have been fractionalized. Sometimes the original holders have died so it is necessary to locate the heirs of those original holders. And often the heirs are unaware that they own a mineral interest. If a mineral rights holder becomes aware that his or her ownership may impede a project, he or she may attempt to use that leverage to obtain a negotiating advantage. If the mineral rights holder is willing to negotiate, the cheapest and most expedient action for a developer is often to purchase the surface entry rights. If the surface entry rights are acquired, the developer can generally proceed, even if subsurface mineral rights remain, with appropriate title insurance coverage.

Typically, the more fractionalized mineral rights are, the less valuable they are for any particular holder because an aggregation of those rights is required in order to make any exploration worthwhile. Often, an aggregation is required not only of the rights on one parcel, but of mineral rights on several parcels, in order to make extraction feasible.

To properly prepare for negotiations with a mineral rights holder, it is helpful to obtain an appraisal of the mineral rights to determine their fair market value. Usually a mineral rights appraiser will compare the cost of extraction of the minerals with the market value of the minerals to determine their value. As mentioned, interests will often need to be aggregated in order to make extraction economically feasible. The main drawback to the negotiation strategy is the cost and time involved in such negotiation, although the alternatives also have cost and time components associated with them.

If all of the owners of the mineral rights are willing, a quitclaim of the surface entry rights to the surface owner will help a title insurer underwrite the risk of insuring against surface access damage. Alternatively, the owners can negotiate certain areas to remain open for exploration and drilling. A title insurer can provide tailored insurance coverage drafted around these specifically created "drilling islands". It is important to remember that these types of arrangements usually also involve easement rights for access (and perhaps utilities and pipelines) across the surface.

B. Termination of Dormant Interests.

The next approach to limit surface rights is to determine if the mineral interest is dormant and subject to termination, pursuant to

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statute. Cal. Civ. Code § 883.210 provides a mechanism for the termination of dormant mineral rights. The purpose of the statute is to avoid a situation where old mineral rights cloud title and prevent a productive use of the property.

A mineral right is considered dormant if all of the following conditions are satisfied for a period of twenty years preceding commencement of the action to terminate the mineral right:

- There is no production, mining, or other development of the mineral rights.
- No separate property tax assessment is made of the mineral right or, if an assessment is made, no taxes are paid on the assessment.
- "No instrument creating, reserving, transferring, or otherwise evidencing the mineral right is recorded."

Satisfaction of the first condition, relating to no production or mining of the mineral, can be verified by an inspection of the real property and review of historical records. Often a mining consultant is hired to inspect the property and mining records and, if needed, to testify that no production or exploration has occurred in the last twenty years.

Satisfaction of the second condition can be verified through a review of the property tax records in the county in which the property is located.

Satisfaction of the final condition can be verified through a review of the public record maintained by the County Recorder and can be more challenging. Often, the instrument "creating, reserving, transferring" the mineral right is more than twenty years old, but within the last twenty years a property description – which may be attached to a deed or a deed of trust – has been recorded which itself reflects the reserved mineral rights. Thus, even though there has been no separate conveyance of the rights, if an instrument has been recorded referencing the rights by, for example, using the original language of reservation, an argument can be made that that instrument "evidences" the mineral rights, and – if the instrument was recorded within the last twenty years – the twenty -year period requirement is not met.

If the conditions of the statute are satisfied, a complaint can be filed in the Superior Court of the county in which the property is located to obtain a determination that the mineral rights have in fact been abandoned. If the current mineral rights holders cannot be located or are unknown, they can be served by publication in a local newspaper. It is not uncommon for known holders of the mineral rights, upon being served with a complaint, to simply disclaim any interest or to not oppose the request for termination. If no one responds to the summons and complaint, request for entry of default can be filed and a default judgment entered.

If a holder of a mineral right does object to the determination of abandonment, he or she has the right to file a "Notice of Intent to Preserve Mineral Right" but as a condition, must pay litigation expenses incurred through the date of that filing. This is often a disincentive to claiming the mineral rights, especially if the mineral right is not particularly valuable or if the cost of exploitation is particularly high.

The process is akin to a quite title action. Once a judgment is entered in the case, it can be recorded with the County Recorder to reflect the termination of the mineral right. The judgment acts as the equivalent as a conveyance of the mineral right to the owner of the real property and, once recorded, may be insured.

C. Termination of Right of Surface Entry in Oil/Gas Leases.

The third mechanism is also statutory, and applies only to oil and gas leases on "lands within a city in any county with a population exceeding 4,000,000, or with a population of more than 700,000 and less than 710,000 as determined by the 1960 Federal Decennial Census." These population prerequisites make this statutory process currently available in cities located in two counties, Los Angeles and Orange. Again, the purpose of the statute is to allow for the productive use of property – particularly in urban areas – where an old oil or gas lease exists. If a lease exists for the production of oil, gas or other hydrocarbons, together with a right of entry or occupation of the surface, the fee owner may obtain a judgment terminating or limiting the right of entry of the surface under the following conditions:

- The document creating the leasehold interest was executed more than 20 years prior, not including any amendments.
- There is no oil or gas well or well bore on the land.
- Termination of the right of entry or occupation of the surface that is requested by the plaintiff, or as may be conditioned by the court, "will not significantly interfere with the right of the lessee, under the lease, to continue to conduct operations for the continued production of oil . . . ." That is, some provision must be made to allow the lessee to continue to access any oil reserves which may exist below the surface.

The main drawback to this statutory provision is that it cannot be used in the less populous counties where it is most likely a solar energy project will be located.

D. Declaratory Relief Regarding Surface Rights.

The fourth mechanism is to obtain declaratory relief under Cal. Code Civ. Proc. § 1060 regarding the respective rights of the surface owners and the mineral rights owner to the surface of

the property. This would be most useful in a situation where there is no express grant, reservation or exclusion of surface rights, and where the "reasonable right to use the surface" standard applies. In such a case, the project proponent can request a declaratory determination from the court, prior to a project being built, that a mineral rights holder should be limited to certain areas or "drilling islands" on the surface of the property in accessing the mineral deposits. The declaration would in essence be an early determination of the type of access that will be permitted under the applicable legal standard, and would allow plans to be made as to where improvements can be located. In order to prepare such an argument, a mining consultant will typically need to be retained to testify as to reasonable means of access to the mineral rights deposits.

In order to make the dispute a "concrete" one, capable of resolution by a court, a specific proposal for surface use and access should be made by the project proponent to the mineral rights holder. If the proposal is rejected, declaratory relief can be sought. The main drawback of this approach is the time required to obtain a final judgment, if no earlier resolution can be recorded.

E. Condemnation.

Finally, certain public entities, including utilities, have the right to condemn property, including mineral interests and/or surface entry rights, and in that situation, condemnation of the mineral or surface entry interests is an option which may be considered. Such a condemnation would require a showing of public necessity, and payment of just compensation to the mineral rights holder.

V. TITLE INSURANCE.

The most common form of insurance is, generally, against loss from the exercise of any right to use the surface of the land for the extraction or development of the minerals.

This type of specific coverage can be provided in the title policy itself, as with the American Land Title Association ("ALTA") or California Land Title Association ("CLTA") 2010 Homeowner's Policy or Expanded Coverage Residential Loan Policy, or on commercial transactions, through endorsements such as the ALTA 9 series of endorsements or the CLTA 100.29 endorsement.

Solar developers will most typically be working with the two endorsements. Prior to 2012, the ALTA 9 series of endorsements provide a whole host of coverages in addition to surface damage protection, including violations of covenants, conditions and restrictions, encroachments, and violations of setback lines. In May of 2012, ALTA approved a new series of endorsements called the ALTA 35 series. This series of endorsements provides varying levels of coverage against damage to improvements resulting from the exercise of rights to use the surface of the land for the extraction or development of minerals or any other subsurface substances.

The CLTA 100.29 endorsement is also specific to insuring against damage to improvements due to the use of the surface to access minerals.

The cost of these endorsements can vary depending on the project. The underwriting required to issue any endorsements will involve many of the steps outlined above, namely identifying whether a severance exists, identifying the owners of the severed rights, and obtaining the necessary documentation to establish a waiver or relinquishment of surface entry rights.

The following chart is a suggested methodology for analysis of surface rights in connection with underwriting the feasibility of solar energy projects.

VI. CONCLUSION.

Our energy climate is changing. As more resources become available and are allocated to alternative energy projects, developers of these projects are going to explore opportunities for development in more challenging areas. While a severance of mineral rights can present a challenge, the right tools can enable a solar project developer to address this challenge and move forward with the assurances it needs.

In the News....

FIRST AMERICAN TITLE INSURANCE COMPANY'S NATIONAL COMMERCIAL SERVICES DIVISION INTRODUCES ITS ENERGY GROUP

Specialized Team of Examiners, Attorneys and Underwriters Work Exclusively on Energy-related Transactions

April 5, 2012, SANTA ANA, Calif.

First American Title Insurance Company's National Commercial Services Division announced today the formalization of its Energy Group, which includes a specialized team of land title examiners, experienced attorneys, project coordinators and insurance underwriters dedicated to working exclusively on energy-related transactions...

to continue, go to: http://www.firstam.com/news/2012/39454.html

Enforceability of Carveouts to Nonrecourse Loans: Recent Cases

By: John C. Murray,

INTRODUCTION

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

BACKGROUND

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

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

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

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laws and regulations affecting the property; failure to maintain the property in a "suitable condition" to prevent loss of value; and removing or "stripping" personal property essential to the use and operation of the property and the buildings and improvements thereon.

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

CMBS LOANS – CURRENT CASES

A. The Chesterfield Decision.

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

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

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

At most, the evidence Defendants present shows that, though both they and Morgan Stanley intended to be bound by the terms of the Loan Agreement, both parties misunderstood the legal effect of the terms contained in that agreement.
Id. at *18.

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

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

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

The court distinguished the "insolvency" exception to the nonrecourse language from the separate exception for a bankruptcy filing by or against Chesterfield, reasoning that the specific bankruptcy exception involved a different interest of a lender than the insolvency exception, i.e., the bankruptcy exception "protects a lender's interest in the collateral and the loan by ensuring that a borrower remains a single-purpose, bankruptcy-remote entity." Id. at *10. The court noted that:

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

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

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

Id. at *13 (emphasis in text).

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

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

Id. at *16.

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

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

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

Id.

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

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B. The *Cherryland* Decision

In another recent case, Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership, 295 Mich. App. 99, 2011 WL 6785393 (Mich. App. Ct., Dec. 27, 2011), based on facts similar (but not identical) to those in the Chesterfield case, supra, the Michigan appellate court held, in connection with a securitized commercial real-estate loan that had been assigned to the plaintiff lender ("Wells Fargo"), that the borrower ("Cherryland") and the individual guarantor (collectively, "Defendants") were liable for the entire loan deficiency of $2.1 million because the borrower was insolvent and had thereby violated the note and mortgage covenants regarding the borrower's failure to maintain its status as a special purpose entity ("SPE").

The court began its decision with a lengthy and comprehensive analysis of the structure of CMBS loans and the concept of "asset isolation," as described by the Commercial Mortgage Securities Association and the Mortgage Bankers Association. The court then rejected Defendants' initial argument that Wells Fargo's foreclosure of the mortgaged property at a Michigan non-judicial foreclosure sale extinguished the mortgage, holding instead that Michigan law was clear that "actions at law are permissible for deficiencies on foreclosures by advertisement." Id. at *5. The court then ruled that Wells Fargo was entitled to specific enforcement of the language regarding solvency in the mortgage provision entitled "Single Purpose Entity/ Separateness," under which one of the covenants provided that Cherryland would remain solvent and pay its debts and liabilities from its assets as they became due.

The court acknowledged that "there are no cases that have held that insolvency is a violation of SPE status," Id. at *11, but quoted at length from a copy of a transcript, provided by Wells Fargo, of a 2001 hearing in Wells Fargo Bank Minnesota, NA v. Leisure Village Assoc, Wayne Circuit Court, Docket No. 00–031860–CZ. According to the Cherryland court, "The Leisure Village documents are slightly different and, arguably, more clearly written, but suggest the same result." Id. at *12. The Cherryland court noted that the Leisure Village case "dealt with, and rejected, all of the arguments made by defendants in this [Cherryland] case." Id. at *13. The Cherryland court held that in this case the particular language regarding insolvency required Cherryland to remain solvent in order to maintain its SPE status; thus its failure to do so triggered "full recourse against the borrower and the guarantor pursuant to the loan documents," Id. at *8, and it was irrelevant which of the listed covenants in the "Single Purpose Entity/Separateness" mortgage provision was actually breached.

The Cherryland court quoted the trial court decision in Leisure Village that such relief "seems extreme" and that the loan possibly could become recourse if the borrower ever failed to pay any debt, but the Leisure Village court noted that the loan agreement executed by the parties provided that the exceptions to nonrecourse were placed in the mortgage "in order to induce Wells Fargo to make the loan and that (similar to the court's reasoning in the Chesterfield case, supra) " [t]he borrowers were apparently not able to negotiate for less strict language and this Court declines to write it into the contract." Id. at *13. The Cherryland court also rejected Defendants' argument that they should not be personally liable because the borrower's insolvency was not caused by its own actions, but rather by the downturn in the real-estate market, holding that "any failure to remain solvent, no matter what the cause, is a violation." Id. at *14. See also LaSalle Bank N.A. v. Mobile Hotel Properties, LLC, 367 F. Supp. 2d 1022, 1029-31 (E.D. La. 2004) (ruling that carveout provision in nonrecourse mortgage providing that debt would become fully recourse to borrower and guarantor if borrower failed to maintain its status as single purpose entity was triggered by borrower's amendment of its limited liability company Articles of Organization, without lender's knowledge or consent, to provide that borrower could engage in other activities, thereby making mortgage a full-recourse obligation), court stated that "motive . . . is . . . irrelevant").

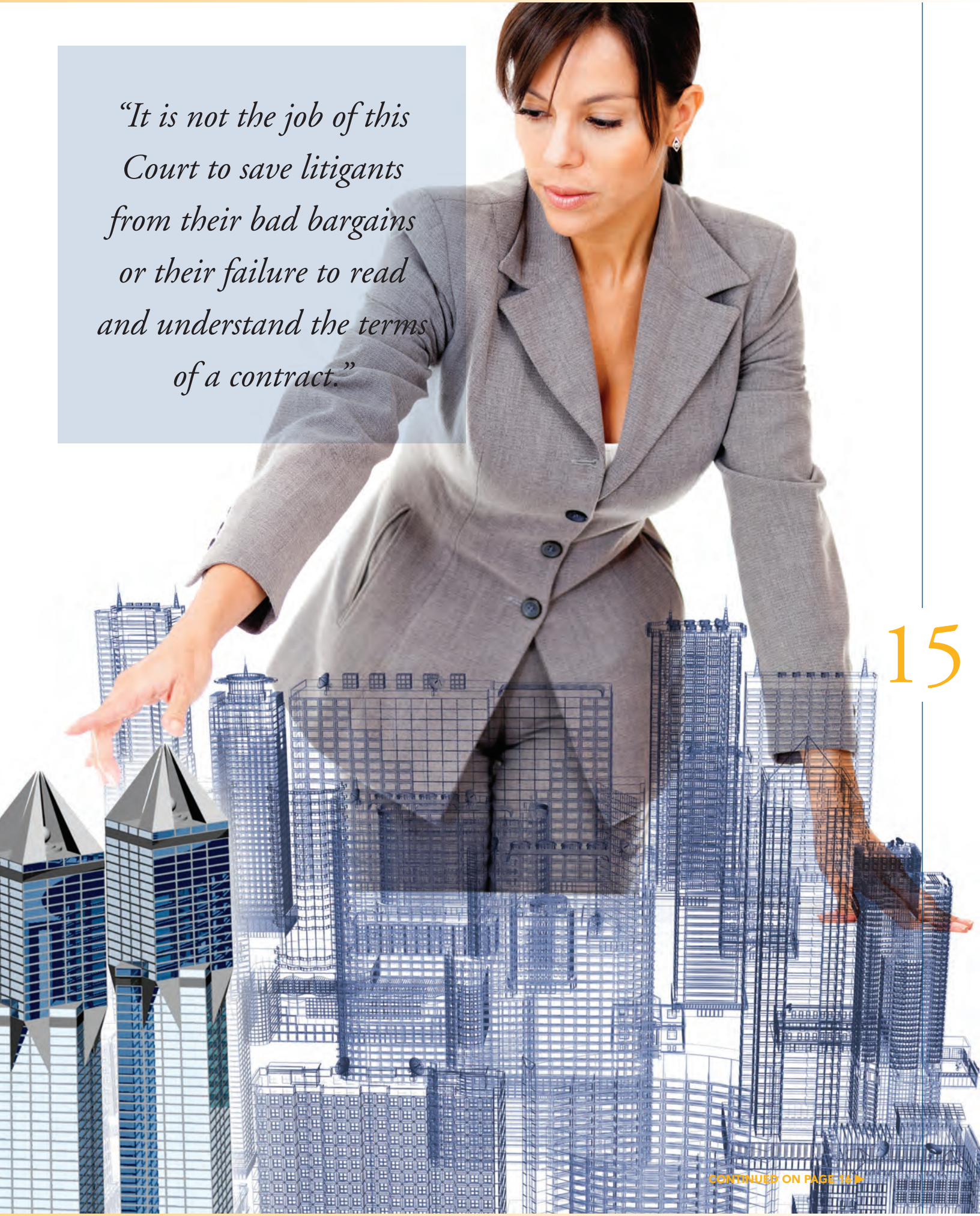
Amicus Curiae briefs were filed arguing on behalf of Defendants in the Cherryland case, alleging that Defendants should prevail as a matter of public policy. But the court rejected the public-policy arguments raised by the amici, finding (similar to the court's holding in the Chesterfield case supra)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

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

CONCLUSION

The Chesterfield and Cherryland cases, supra, have certainly gotten the attention of mortgage lenders and commentators. See, e.g., Prof. Dan Schechter, Borrower's Default and Insolvency Constitute Violations of "Separateness" Covenants, Thus Triggering Recourse Provisions in Note and Guarantee, 2012 COMM. FIN. NEWS. 4 (2012) (discussing Cherryland case and arguing that "bad act" of borrower's insolvency was attributable solely to circumstances beyond its control and that an allegedly nonrecourse obligation is meaningless if it only exists until default occurs); The guarantor in the Cherryland case has made application for leave to appeal the Michigan appellate court's decision, and several parties (including the Michigan Attorney General) have made application to file Amicus briefs in support of the borrower/guarantor. (The author understands that the Chesterfield case also is in the process of being appealed.)

Taking to heart the court's admonition in Cherryland that that it is the role of the legislature, and not the court, to address matters of public



"It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."

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policy, the Michigan legislature quickly passed a bipartisan bill, S.B. 992, which was introduced on February 29, 2012. The bill, to be known and cited as the Nonrecourse Mortgage Loan Act ("Act"), was signed into law by Gov. Rick Snyder on March 29, 2012. The Act regulates the enforceability of certain loan covenants in nonrecourse commercial loans in Michigan and is a direct result of the holdings in the Chesterfield and Cherryland cases, effectively making the deficiency judgments rendered in those cases unenforceable and overturning those rulings.

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

It is likely that as a result of the respective federal and state court decisions in Chesterfield and Cherryland (notwithstanding the passage of the Act), attorneys for lenders and borrowers (especially in connection with CMBS loans and commercial loans on property in states other than Michigan) will in the future negotiate and draft nonrecourse provisions in loan documents (including separateness covenants and isolation of cash flows) much more carefully and precisely to prevent any similar "semantic" issues from occurring. The Chesterfield and Cherryland cases arguably may be limited by their specific facts (notably the strict analysis and interpretation of the language contained in the nonrecourse and carveout provisions, which, as noted by the court in each case, was in its view not ambiguous or subject to reformation), but it serves as a "wake-up call" with respect to negotiating and drafting non-recourse provisions (and carveouts thereto) to reflect exactly the parties' intentions and expectations. Careful borrowers' and guarantors' attorneys have in fact negotiated out the "offending" language in non-recourse carveout provisions (i.e., insolvency covenants, "fail to pay" covenants, and certain SPE covenants) in the past with respect to CMBS (and other commercial) loans. As noted earlier, the court in Chesterfield stated that Defendants were free to negotiate the terms of the non-recourse carveout provision that were more favorable to their interests, but failed to do so. The role of the borrower/guarantor's attorney is crucial in this connection. For example, if the borrower/guarantor's attorney discussed this issue with the borrower/guarantor and was unable to negotiate out the offending SPE and insolvency provisions after warning the borrower/guarantor of the possible negative consequences, there may be no cause for a court to order reformation to conform to the alleged intent of the parties.

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

A Practical View of the 2011 ALTA/ACSM Land Title Survey Standards and Changes

By: Eric C. Jones, Division Manager and Chief Operating Officer
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On February 23, 2011 the 2011 ALTA/ACSM Land Title Survey Standards (ALTA Survey) went into effect, the first update to the standards since 2005. There are two distinct macro areas of concern that are often confused when it comes to ALTA Survey standards. First, are the standards themselves that make up the requirements that must be adhered to for a survey to be considered an ALTA Survey. Next, are the Table A items, which are optional. In addition to the ALTA proposed Table A Items additional Table A items may be added as agreed upon between the surveyor and the party commissioning the survey. The important distinction to remember is the difference between requirements and options or Table A Items.

2011 ALTA SURVEY PURPOSE:

In order to better understand the requirements of an ALTA Survey it is important to understand the primary purpose of the ALTA Survey. Simply stated the purpose of a 2011 ALTA/ACSM Survey is to remove the "Survey Exception Language" from the Title Insurance policy for both Owner's and Lender's Title insurance coverage, what is also commonly referred to as providing Extended Coverage. From a pragmatic point of view the extent that the standards can be deviated from is purely dependant on the willingness of the Title Insurer to provide the insurance coverage required by the buyer and/or lender for the real property transaction. The fact that many ALTA Surveys are used as a Title Insurance Underwriting tool on subsequent transactions enhances the credence of making certain the standards are adhered to on the current transaction.

What one Underwriter may not accept for writing a policy today not be what is required by another Underwriter on a future transaction involving the same property, even from the same company. Making certain that the ALTA Survey is done in accordance with the standards greatly extends the value of the due diligence work performed today by increasing its acceptability to be used in future transactions. This does not mean that the parties may not convince the current Underwriter to use an instrument that deviates from the ALTA Standards to provide the same coverage as it would if a Standard ALTA Survey were provided. This is up to each Underwriter or Underwriting Office who must weigh many other due diligence matters within a given transaction.

THE STANDARDS:

Many of the standards provide guidance and clarification for the level of detail, accuracy and type of information the Surveyor needs to provide, while others provide clarification with little controversy or need for discussion. One area that has spurred many heated debates particularly among Lenders and Lenders Counsel falls in Section 7 Standard Certification for all ALTA/ACSM Land Title Surveys:

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Certification - The plat or map of an ALTA/ACSM Land Title Survey shall bear only the following certification, unaltered, except as may be required pursuant to Section 3.B. above:

To (name of insured, if known), (name of lender, if known), (name of insurer, if known), (names of others as negotiated with the client):

This is to certify that this map or plat and the survey on which it is based were made in accordance with the 2011 Minimum Standard Detail Requirements for ALTA/ACSM Land Title Surveys, jointly established and adopted by ALTA and NSPS, and includes Items of Table A thereof. The field work was completed on _____.

Date of Plat or Map:_____ (Surveyor's signature, printed name and seal with Registration/ License Number)

The significant change from 2005 to 2011 is not in the certification language but that the specific certification language is no longer suggested it is required and unaltered. The question frequently asked here when presenting a client with this information is, "how can we get around this?" The most direct answer is that for the survey to truly adhere to the ALTA Survey Standards it must have the prescribed certification language.

Many surveyors will argue that the State Board, the issuer of their license, will penalize them for not maintaining a certain level or professionalism calling a Survey an ALTA 2011 Survey without adhering to the prescribed standards. It is likely that if you shop around you will find a Surveyor who will certify to most any language you desire. Similarly it is highly probably that you will find an underwriter somewhere who will provide extended coverage without an ALTA compliant survey. Keep in mind that ALTA is a voluntary organization and as such does not have the power or desire to police whether or not their members (Title Companies) require that all surveys meet the standards. The question remains what happens if and when you change Lenders or Underwriters. The whole purpose of the standards is to make certain that everyone agrees to what is acceptable for a Title Insurance transaction regardlesss of Insurer or Lender.

In Section 4 of the ALTA Survey Standards regarding record research it is clearly stated that, "the Surveyor will be provided with appropriate data which can be relied upon in preparation of the survey".

Records Research - It is recognized that for the performance of an ALTA/ ACSM Land Title Survey, the surveyor will be provided with appropriate data which can be relied upon in the preparation of the survey. The request for an ALTA/ACSM Land

Title Survey shall set forth the current record description of the property to be surveyed or, in the case of an original survey, the current record description of the parent parcel that contains the property to be surveyed. Complete copies of the most recent title commitment, the current record description of the property to be surveyed (or, in the case of an original survey, the parent parcel), the current record descriptions of adjoiners,…

What is not stated in Section 4 is who will provide the research data to the Surveyor. Some of the data such as the most recent title commitment will clearly come from the Title Insurer; however, the source may not be as clear for other data like the current record descriptions of adjoiners. The language seems to infer that it is the Title Company that will provide this data, but the language is ambiguous. A classic example is a golf course that may have well over a hundred adjoiners. There is a significant amount of work involved in searching all of the adjoiner data. The biggest concern with this issue is getting several weeks into a transaction without there being an agreement of who is going to provide the Record Research information and at what cost. No one wants to see a transaction get delayed if these types of issues aren't addressed and agreed to very early on in the process the potential for delays increases exponentially.

TABLE A:

Table A are optional items that are to be included with the survey as agreed to by the Surveyor and the parties commissioning the survey. Some of the changes to Table A are relatively straight forward, such as Table A Item 2 which was changed from providing a vicinity map to providing the address of the property. The vicinity map has become relatively standard in the survey industry therefore it makes sense that it was moved from Table A to becoming a standard requirement. The address may seem very important to some, but from a Title Insurer and Surveyor perspective the legal description is critical and the property address is not particularly interesting, except the address's relevance to municipal zoning matters, fraud protection and discrepancies.

Table A Item 6 (a) & (b) calls for the Surveyor to place specific zoning information on the survey, (a) zoning classification or (b) zoning classification, building set back requirements, height and floor space area restrictions, respectively. The area of concern regarding Item 6 is that it states, "as provided by the insurer". This language is likely included because Title Insurers have specific zoning endorsements they write with the exception of states where zoning

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"If you are concerned about E&O insurance, you should forget about E&O and take a better look at the firm that is providing your due diligence work!"

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endorsements are prohibited such as Texas and Florida. That said, many of the Title Insurance Representatives I have spoken to are not accustomed to or equipped to provide this information to the Surveyor. It should also be noted that ALTA does not say the Title Insurer is obligated to provide the information free of charge. The Insurer can simply decline to provide the information.

Often zoning research companies, such as First American Commercial Due Diligence Services, are contracted to perform this research. Zoning information is very important to many clients and it is imperative that the provider of this data and cost are clearly indentified early on in the project. Again the biggest concern with this issue is getting weeks into a transaction that now becomes delayed; has new undisclosed fees; or worse yet a Surveyor place a note on the face of the survey "not provided by title" rather than providing the parties to the transaction the requested due diligence.

Another area of interest is Table A Item 11 (a) & (b). 11 (a) calls for the Surveyor to locate and depict above ground utilities and 11 (b) calls for the surveyor to locate and depict above and below ground utilities. The language for both above and below ground utilities uses the important qualifying word observable. Simply said even though the client may want to know the details of how below ground utilities run across the subject property the Surveyor can only depict what they can either directly observer or have other documentation to attest to the specific location. The third option of course is to excavate in order directly observe what is underground, a very costly and time consuming proposition.

Table A item 20 (a) & (b) are two other items that could potential add significant unnecessary cost to a survey. Item 20 (a) calls for the Surveyor to specifically locate improvements within any offsite easements or servitudes benefiting the property. Item 20 (b) calls for the Surveyor to place monuments or witness to the corners of any offsite easements or servitudes benefiting the property. Each of these options could add significant costs to the survey and may be unnecessary.

Consider what Table A Item 20 (a) is asking of the Surveyor in the context of a subject property such as a fast food restaurant located on a pad site at the corner of a shopping plaza. Many of the shopping plaza roads may feed the pad site thereby benefiting the subject property. Table A Item 20 (a) tells the surveyor to locate all of the improvements that belong to the properties that these roads traverse. In essence the surveyor is now required to survey and access the subject property and the entire shopping plaza. There are a few instances where this may be necessary, for example if the subject property had specific rights to the parking areas in and around the offsite improvements, but otherwise it is likely that this is costly and unnecessary surveying.

If you are concerned about E&O insurance, you should forget about E&O and take a better look at the firm that is providing your due diligence work!

A similar concern exists with Table A Item 20 (b) which in this instance we are requesting that the Surveyor either place or witness all of the major corners of the roads through the shopping plaza that are feeding our subject property. Again this may be surveying that is expensive and unnecessary. Furthermore the property owner of the shopping plaza may not appreciate having the fast food restaurant's Surveyor place monuments on each of the corners of the shopping plaza owner's road. Both of these cases are examples where setting the right requirements up-front and working with a Surveyor who will help you understand what truly needs to be surveyed up-front to help you avoid costly and possibly unnecessary due diligence work.

First American Commercial Due Diligences Services offers our own Table A item that we have numbered "24" (the ALTA published options end at 21) that calls for the surveyor to simply graphically depict offsite easements or servitudes as described in the title commitment that benefit the subject property. We believe that in most instances this provides the information the parties to the transaction need concerning easements or servitudes that benefit the subject property without adding significant cost, time or unnecessary surveying to the due diligence work.

Table A Item 21 calls for the Surveyor to provide Professional Liability Insurance often referred to as E&O (Errors & Omissions) Insurance. Interestingly the amount of insurance is left blank. First American Commercial Due Diligence Service has carried E&O Insurance for years; however, the E&O insurance really protects the Surveyor not the client. If you are working with a firm that does not have E&O insurance you may want to look at the financial security of that firm as a whole. That said the E&O insurance really means is that if there is an issue you will most likely have to work the issue with E&O provider's attorneys rather than the Surveyor. Other questions to consider might be:

- Does the policy have a tail or is it good only until the transaction is done; and what defines what is done?
- What happens if the surveyor goes out of business or doesn't keep the policy instated?
- If you are concerned about E&O Insurance, you should forget about E&O and take a better look at the firm that is providing your due diligence work!
- What is the financial strength of the survey firm?
- Can they suffer a claim or would a claim essentially put them out of business?
- Finally you may want to consider if the firm has General Liability Insurance that protects their workers and your property when they are conducting the survey on-site.

A WORD ABOUT CLAIMS:

In the world of survey or at least as it pertains to ALTA Surveys there are really only two types of claims. The

first are those claims that are covered by the Title Insurance Policy and the second are those claims that are not covered as part of the Title Policy. Remember the whole reason why the ALTA Survey was commissioned in the first place was to provide Extended Title Coverage. In the case of a claim that was covered by Title the owner or lender files a claim with the Title Company and then it is either paid or denied regardless of whether or not the claim resulted from an issue that should have or have not been identified in the survey. If the Title Company finds that the claim arose from a survey matter that Title Company would be obligated to pay the claim to the buyer or lender and then go after the Surveyor or the Surveyor's E&O provider to recoup the monies the Title Company paid out on the claim.

There are instances when the Title Company may deny a claim but the property owner may still have recourse with the Surveyor. For example an Agricultural Firm buys a section of farmland including extended title coverage. The Surveyor produces a survey that includes both the farmland that is part of the legal description and part of the Title Insurance, as well as some additional land that the surveyor mistakenly included as part of the survey or acquisition. The transaction closes and the Agricultural Company begins farming the entire piece of land depicted in the survey. They soon find out that the owner of the piece they are farming the Surveyor depicted but Title did not insure is owned by someone else who wants to be reimbursed for the farming of their land. The Agricultural Company immediately files a claim with the Title Company. The Title Company immediately denies the claim stating they did not write a Policy for the land in question. The Agricultural Company most likely has a legitimate claim against the Surveyor:

- **Does the Surveyor have the financial strength to suffer the claim?**
- **Did the Surveyor have E&O insurance at the time they completed the project?**
- **Did the E&O Insurance have a tail?**
- **Does the Surveyor still use the same E&O provider?**

Arguably if question one above is true it does not really matter what the answer to the remaining questions are, except whether or not will you be dealing with the Surveyor or the E&O Provider's attorneys. The bottom line is regardless of the size of your project or who you are using for underwriting you need to know that you are not only going to get quality work, but that the work will be backed by a firm that has the financial means to suffer a claim should one arise.

CONCLUSION:

One of the key considerations for both the ALTA Survey Requirements and optional Table A items is to consider the purpose of the ALTA Survey which is to satisfy Title Underwriting needs to provide Extended Coverage. In consideration of this it is very important to adhere to the 2011 ALTA Survey Standards, including certification language, to make certain that the value of the due diligence work cannot only be extracted from the current transaction but from future transactions regardless of Underwriter or Lender. As early on in the project as possible it is essential that all parties to the transaction including the Surveyor, Title Company, Lender, etc… clearly communicate and understand who is responsible to provide what. Communication is the key to avoid delays because of missing research data such as adjoiners or zoning information. Communication is also the key to make certain that the right amount of surveying is being done to satisfy the needs of all parties to the transaction. Working with an excellent survey firm will insure they advise you properly upfront to avoid unnecessary charges; provide quality work; and have the financial backing necessary to suffer a claim that may fall outside of what is provided by the Title Insurer.

There are a number of changes that are part of the ALTA 2011 Standards and optional Table A items that you need to be aware of. From very specific requirements and language that must be used in the Certification to optional items that can double or quadruple the cost of the due diligence work. Understanding these changes is critical.

- Did you know that one of the new ALTA/ACSM Table A items calls for the surveyor to have professional liability insurance? More importantly what doesn't it say…
- Does the policy have a tail?
- Is it good only until the transaction is done?
- What happens if the surveyor goes out of business or doesn't keep the policy instated?
- If you are concerned about E&O insurance, you should forget about E&O and take a better look at the firm that is providing your due diligence work!

Why It's a Good Idea to Do an Exchange in This Market

By Mary Kay Kennedy, National Operations Manager
First American Exchange Company

Mary Kay Kennedy

With falling property values and the availability of other losses to offset gains, there is a perception in the marketplace that it is not worthwhile to do a 1031 exchange anymore. While it is true that capital gains rates are relatively low and the amount of gain from appreciation is less than it was before the recession, there are some less obvious factors that will influence the amount of tax that is due when selling investment property and may make an exchange desirable.

TAX ON GAIN FROM APPRECIATION IN VALUE

The most obvious tax liability is the federal capital gains tax, at a maximum 15% rate, on the "gain," which in basic terms is the difference between the sales price and the price that the investor originally paid for the property. This rate was lowered from 20% to 15% as a part of the Jobs and Growth Tax Relief Reconciliation Act of 2003, which was extended and is currently scheduled to expire at the end of 2012. Therefore, even if Congress takes no action, the federal capital gains rate will go up to 20% in 2013.

RECAPTURE OF DEPRECIATION

In addition to paying capital gains tax on appreciation, an investor must pay tax at a higher rate (25%) on the depreciation that was taken during the investor's ownership of the property. This means that even if there is no appreciation in value between the time the property is acquired and it is sold, there will still be tax due because of recapture of depreciation.

GAIN FROM PRIOR EXCHANGES

Each time an investor completes a 1031 exchange, the tax on the gain is deferred and is not due until the replacement property is sold. If the investor does another exchange at that time, the obligation to pay tax on the gain is deferred again. If the investor eventually decides to cash out instead of doing an exchange, at that time the tax that was never paid is due. Because of this, it is important to consider gain from prior exchanges when determining how much tax will be due on a disposition.

STATE TAX

In some states you must also pay state tax on appreciation and recapture of depreciation. This state tax can be at a rate as high as 11%. Although Internal Revenue Code Section 1031 is a federal statute, most states incorporate it as-is into their tax structure, so you can defer both federal and state tax when doing a 1031 exchange.

3.8% "MEDICARE TAX"

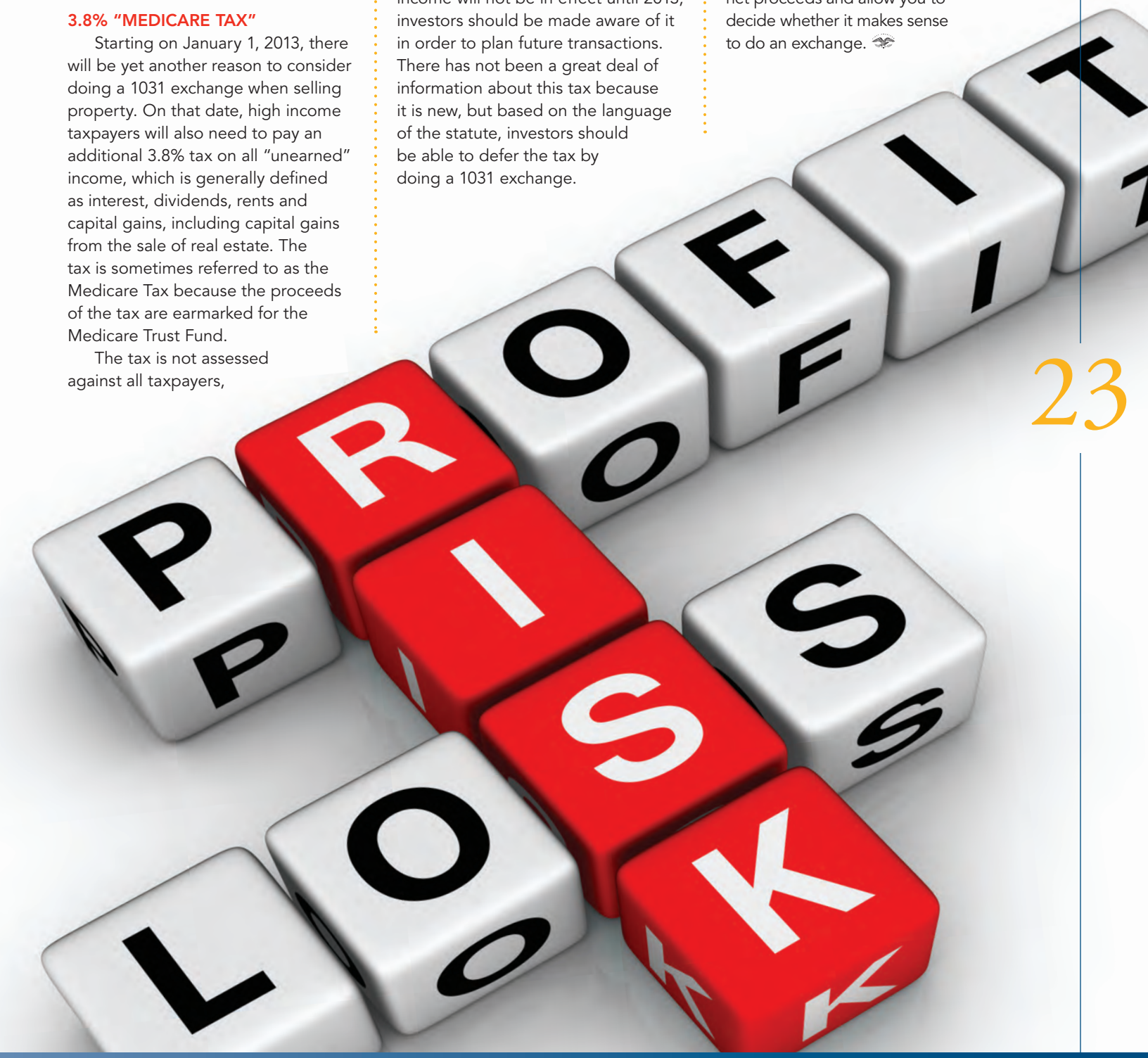
Starting on January 1, 2013, there will be yet another reason to consider doing a 1031 exchange when selling property. On that date, high income taxpayers will also need to pay an additional 3.8% tax on all "unearned" income, which is generally defined as interest, dividends, rents and capital gains, including capital gains from the sale of real estate. The tax is sometimes referred to as the Medicare Tax because the proceeds of the tax are earmarked for the Medicare Trust Fund.

The tax is not assessed against all taxpayers, however. It is only imposed to the extent the taxpayer's adjusted gross income is higher than $200,000 for an individual or $250,000 for a married couple. A single taxpayer with adjusted gross income of less than $200,000 will not have to pay this tax, even if the taxpayer sells property and needs to pay capital gains tax on the sale.

Although the tax on unearned income will not be in effect until 2013, investors should be made aware of it in order to plan future transactions. There has not been a great deal of information about this tax because it is new, but based on the language of the statute, investors should be able to defer the tax by doing a 1031 exchange.

CONCLUSION

As you plan to sell your properties in 2012 and 2013, you should take into account the tax that will be due not only on appreciation in value but also on recapture of depreciation. The tax may include federal and state taxes, plus in 2013 a tax on unearned income. Having a complete understanding of what tax will be due will give you a clear idea of what you will receive in net proceeds and allow you to decide whether it makes sense to do an exchange.



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ULI Urban Land Institute
www.uli.org
▸ ***Fall Meeting & Urban Land Expo***
October 16-19, 2012 • Denver, Colorado

MBA Mortgage Bankers Association
www.mbaa.org
▸ ***99th Annual Convention & Expo***
October 21-24, 2012 • Chicago, Illinois

PREA Pension Real Estate Association
www.prea.org
▸ ***22nd Annual Plan Sponsor Real Estate Conference***
October 22-24, 2012 • Los Angeles, California

NAIOP National Association of Industrial & Office Properties
www.naiop.org
▸ ***Development '12: Annual Commercial RE Meeting***
October 22-25, 2012 • Washington, D.C.

CREW Network Commercial Real Estate Women
www.crewnetwork.org
▸ ***Annual Convention & Marketplace***
October 24-27, 2012 • Chicago, Illinois

ICSC International Council of Shopping Centers
www.icsc.org
▸ ***US Shopping Center Law Conference***
October 24-27, 2012 • Orlando, Florida

NAREIT National Association of Real Estate Investment Trusts
www.reit.com
▸ ***REITWorld®: NAREIT's Annual Convention***
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