ACREL News

President's Message

I am very much looking forward to assuming the role of President of ACREL for the coming year, even though we are certainly in the middle of "interesting times." Given the wealth of experience in the Executive Committee, the Board of Governors, and our Fellows, I believe we can continue to make ACREL stronger and continue to provide outstanding services to our Fellows.

First, a special thanks to Mark Mehlman for the wonderful job he did during the preceding year, and for involving me deeply in the College's activities to prepare for the coming year. Also, thanks to Rebecca Fischer and Bill Carr, outgoing governors, and to Jonathan Shils who was the at-large-member of the Executive Committee last year – each of them made strong contributions for the benefit of all of us.

It is especially gratifying to assume the mantel following an extremely successful meeting in San Francisco, celebrating the 30th anniversary of ACREL. The social activities, tours, and dine arounds were well received – there were 88 participants in the dine arounds, 103 people went to Beach Blanket Babylon, and 213 people went on the tours. Eight charter fellows attended, as did 14 past Presidents and 26 new Fellows. The CLE program was simply outstanding, with a wide range of participants, including speakers provided by the Mortgage Bankers Association who were able to share with us their experiences in the current market. If you have not done so, please visit the web site to view the power points from the presentations, including the presentation of David Wright, the group Vice President of the Federal Reserve Bank of San Francisco. Also, be sure to check out the video of the 60's party that was held on Saturday night – it is well worth the few minutes it takes to watch it, and for those of you unable to make it to San Francisco you will find some enlightening views of your Fellows.

Our next meeting is scheduled for March 26th through the 29th at the Westin Rio Mar in Rio Grande, Puerto Rico. It should be a wonderful venue coupled with a tremendous program. Meg Meister and the Programs Committee are well into the planning for the CLE program, which will cover a number of very timely topics, including retail

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bankruptcies, workouts, the ramifications of the new government intervention programs, and a panel discussing how the real estate community is likely to respond to the new regulatory framework. There will also be topics on wind leases, ethics, and hot tips, along with the professors' corner and the usual interesting array of workshops. We very much hope that you will be able to attend what promises to be a truly interesting meeting in an exceptional venue.

In keeping with our efforts to expose the benefits of ACREL to a wider audience and to further build the ACREL brand, through the efforts of Jonathan Shils and Mark Mehlman the College arranged for a panel to make a presentation to the Mortgage Bankers Association regarding issues that borrowers' counsel are seeing in the marketplace today. Mark, David Kuney, and Nancy Little were the panel participants, and a more detailed report on that presentation will be included in a subsequent newsletter.

STAFF BOX

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Finally, there are a number of initiatives, both continuing and new, that will be undertaken in the coming year. Kevin Shepherd's continued efforts with the FATF Gatekeeper Initiatives will move into the next phase. Kevin has kindly agreed to chair a task force of representatives from the Real Estate Synergy Group to work on developing good practice guidelines. This group will include representatives from the American College of Mortgage Attorneys, the ABA Real Property Trust and Estate Section, the ABA Business Law Section, the American College of Commercial Finance Lawyers, the Commercial Real Estate Women Network, and the International Council of Shopping Centers Law Conference. We are also establishing a task force to address the changing face of the practice of real estate law and its impact on the College – Linda Striefsky has agreed to lead this endeavor.

In short, although times are currently trying, we look forward to an exciting, interesting, and successful year. If you have ideas for the betterment of the College, or for the provision of better services to our Fellows, please let me or any of the Board know.

Best wishes for the coming year.

Phil

Philip D. Weller, President

Baseball Arbitration and Coin Tosses

by Harris Ominsky, Philadelphia, PA

> *"I was never ruined but twice. Once I filed a lawsuit and lost, the other when I filed a lawsuit and won."*
>
> Voltaire

Years ago, I settled the split-up of a small real estate empire by a coin toss. Yes, a coin toss! No appraisers, no mediators, no depositions, no litigation, no anguish – no big fees. I did it on just a call of "heads" or "tails."

The participants were my friends, and I had represented both of them. I could have sent them to other attorneys, but I decided to gamble a little.

Experts recommend more traditional methods to resolve disputes without litigation. These include AAA arbitration and trained mediators. Books and pamphlets provide us with alternative forms of arbitration and mediation clauses to use in our contracts. But you're not likely to find any clauses on coin tosses.

Splitting the Baby

The problem some feuding parties have with these traditional methods is that they're afraid somebody will undermine them with Solomon's Biblical ploy to split the baby. They may each have strong feelings that they are right, and don't want some third party to simply split the last offers down the middle. They figure that even though Solomon got away with it in the Bible, that doesn't work in real life. Arbitrators may be, well, arbitrary, some say. Like a flip of a coin.

Despite that reservation, those people-of-little-faith are not correct about the way most arbitrators resolve issues. Years ago, a special study of the American Arbitration Association showed that only 12% of arbitrators compromised at 40% to 50% of the competing offers. On the other hand, 21% completely denied the claim, and 33% awarded between 80% and 100% of the claim.

Baseball Arbitration

When someone is requesting a financial award, such as the amount of damages or a disputed salary, some suggest "baseball arbitration." What is "baseball arbitration?" There's not even agreement on that.

Some describe it as a system where each side selects an arbitrator, and then those two select a third. Each of the three comes up with a number. Then you average the two closest numbers and discard the third.

Most describe baseball arbitration as even less cumbersome. Each side submits a figure and an arbitrator chooses one of those figures. That comes from Article VI.F (5) of the Basic Labor Agreement between Professional Baseball and the Players' Association, which provides:

> … the arbitrator or arbitration panel shall be limited to awarding only one or the other of the two figures submitted.

Either of these systems will encourage realistic figures and discourage "splitting the baby." If you intend to gain leverage by high-balling or low-balling, you gamble that your submitted figure may be completely discarded. It sounds like gamesmanship, or even sports.

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Baseball Arbitration and Coin Tosses

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The Coin Toss

That brings me back to the coin toss. I had helped my friends acquire over a dozen apartment projects, but they had decided that they could no longer live together after many years of bickering. They wanted to split up the properties without litigation, so I encouraged them to prepare two equal packages of all of their properties. They knew that they would have to be even-handed and practical in dividing them up because they would not know who received which package until they completed a coin toss. I drafted a simple letter agreement describing the two packages and spelling out that the winner would get first choice.

On "game day" both participants appeared in my office and I tossed the coin into the air. As one called "heads," the coin hit the ceiling and came down on the floor face up.

The losing partner immediately protested that we should do it again, on the grounds that when a coin hits a ceiling, a toss does not count. In one second flat, the peace that I had brokered had been broken and the partners were feuding again.

How I resolved that dispute is not important, but remember, coin tosses can settle disputes. I know, because we used to do it that way in my old West Philly neighborhood. We would even joke, as we did the toss, "Heads I win, and tails you lose."

If you want to use the Ominsky coin-toss arbitration provision, I'll contribute this one to you at no cost:

> The two partners shall list all of the properties in the partnership and agree on a division of all of them into two separate packages of properties that are approximately equal in value. The parties shall then arrange for a coin-tosser to flip a coin in the air, and designate a partner to call either "heads" or "tails." The winning partner from the toss shall choose which package of properties he shall receive. The losing partner shall receive the other package. The coin tosser shall have no liability resulting from a defective or faulty coin toss. The toss shall be final, valid and of full force and effect <u>even if the coin hits the ceiling</u>.

As you may remember, we have precedent for coin flips from another sport. So far as I know, no one ever decided on who receives the football kickoff by arbitration or mediation. ■

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

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

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

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

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

The specific language of the Protective Safeguards Endorsement (ISO form IL 04 15 04 98) provides that the carrier will not pay for loss or damage by fire if the insured "**. . .** knew of any suspension or impairment in any protective safeguard listed in the Schedule **. . .** and failed to notify [the insurer] of that fact; or **. . .** failed to maintain any protective safeguard listed in the Schedule **. . .** , and over which [the insured] had control, in complete working order." The safeguards include an automatic sprinkler system, an automatic fire-alarm system, a security service with recording or watch clocks making hourly inspections of the entire premises when not in operation, a private fire department contract, and other items that can be specifically listed in the schedule of the endorsement.

While this answer would not materially affect my response to the proposed lease language noted above, it provides a good reason why a landlord's lease form should both specify the particular use which the tenant will make of the premises and allow absolutely no alterations to the premises without the landlord's approval, and why tenant's counsel might be well advised not to object too strongly to such provisions. Additionally, landlords (and their attorneys) should have alteration plans reviewed not only by engineers, but by insur-

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Insurance: What You Don't Know ...

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ance professionals as well, so that the insurance professional can determine if the carrier needs notice of the alterations. The relatively common exception allowing a tenant to make non-structural interior alterations, which do not affect building systems and do not cost in excess of a stated amount, could easily result in a loss of the landlord's fire-insurance coverage. After an uninsured loss it would be of little solace (to the landlord or to the tenant) to find that the tenant was in fact required to obtain prior approval of the plans because they "affected" the building's sprinkler system but did not on the assumption that they were non-structural and below the cost threshold. And woe to the poor tenant's attorney who is asked by the tenant to look at the lease and comes to the same conclusion. Similarly, an "any lawful use" clause that allows a tenant to change uses without notice to the landlord could expose the landlord to a loss of fire insurance proceeds if the lawful use was to a use group with sprinkler specifications more stringent than those in existence at the premises.

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

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

ACREL News Online!

We're going electronic! Many of you have told us that an online newsletter is more useful than a paper one. You may not have realized, but individual articles are available under the "Publications" link on the ACREL website, and the entire issue is posted as a pdf file each time it is published.

Now, we'd like to move everything online. In doing this, we'll solve some storage problems (yours and ours), save some money, and save a few trees. We recognize that some people still prefer "hard copy." If you're one of them, just let us know (email jhpace@acrel.org or hlkeller4501@acrel.org, or send a fax to 301-816-9811, or write an actual letter to ACREL, 11300 Rockville Pike #903, Rockville, MD 20852), and we'll be happy to mail you a copy of the ACREL News when it is published.

Defining the Contours of Subrogation

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

Subrogation is the substitution of one person in place of another so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies, or securities. *Jackson Co. v. Boylston Mutual Ins. Co.*, 139 Mass. 508, 510, 2 N.E. 103, 104 (1885). Defining its contours is elusive. There are two broad categories of subrogation rights; contractual or conventional rights, and common law or equitable rights. One court describes equitable subrogation as a creature of chancery that is utilized to prevent unjust enrichment. *Aames Capital Corporation v. Interstate Bank of Oak Forest*, 315 Ill. App.3d 700, 734 N.E. 2d 493 (2000). There is no general rule that can be laid down to determine whether a right of equitable subrogation exists, since the right depends upon the equities of each particular case. Borrowed from English courts of equity, equitable subrogation simply seeks to maintain the proper order of priorities. *Burgoon v. Lavezzo*, 68 App. D.C. 20, 92 F.2d 726, 829 (1937).

On the other hand, conventional subrogation arises from an agreement between the parties that the subrogee pay a debt on behalf of a third party and, in return, be able to assert the rights of the original creditor. *Aames Capital Corp.* supra It has been defined as a right springing from an express agreement with the debtor where the subrogee advances money to pay a claim, which carries a lien, and where the subrogee and the debtor agree that the subrogee is to have an equal lien to the one paid off. *Aames* at Supra p. 706.

Subrogation applies in many contexts. While its overall purpose is preventing unjust enrichment, many times the requirements will be tailored to the particular nuances of the situation. Four recent cases have addressed the contours of equitable and conventional subrogation in the context of refinancing mortgagees. *Bank of America v. Prestance Corp.*, 160 Wn 2d 560, 160 P. 3d 17 (filed June 7, 2007), *Union Bank v. Thrall*, 374 Ill. App.3d 785, 872 N.E. 2d 542 (June 29, 2007), *JP Morgan Chase Bank v. Howell*, 876 N.E. 2d 1171, 2007 WL 4126473 (Ind. App., Nov. 21, 2007), *Ex Parte Lawson v. Brian Homes*, 2008 AIG LEXIS 154.

1. Bank of America v. Prestance Corp., 160 P. 2d 560 (Wash. June 2007)

In *Prestance*, the court considered whether a lender can be equitably subrogated to a first priority lien despite having actual or constructive knowledge of junior lienholders. Washington Mutual (WAMU) had a first-priority lien on the borrower's personal residence while Bank of America (BA) had a second-priority lien. Wells Fargo Bank West (WFB West) sought to be equitably subrogated to WAMU's first priority position because it paid the borrower's debt to WAMU.

The court discussed three different jurisdictional approaches in addressing the issue. First, the Restatement of the Law (Third) – Property (1997) ("Restatement") approach says actual or constructive knowledge of intervening interests is irrelevant. Second, a minority approach holds that a plaintiff with either actual or constructive knowledge cannot seek equitable subrogation. Third, a majority approach allows equitable subrogation on behalf of a plaintiff with actual knowledge, as opposed to constructive knowledge. The court ultimately adopted §7.6 of Restatement, and held that a refinancing mortgagee's actual or constructive knowledge of intervening liens does not automatically preclude a court from applying equitable subrogation.

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The court emphasized subrogation's overall purpose as a doctrine "of equity and benevolence" and its basis as the doing of complete, essential and perfect justice between the parties, without regard to form and its object of injustice. The court noted that equitable subrogation maintains the proper scheme and original priorities. Therefore, it should not be allowed if a junior interest is materially prejudiced. The question in such cases is whether the payor reasonably expected to get security with a priority equal to the mortgage being paid. When dealing with refinancing as opposed to mistakes, there is no reason to consider the subrogee's knowledge of intervening interest.

The Court's reasoning was guided by two policy considerations in support of the Restatement approach. First, by facilitating more refinancing, equitable subrogation helps stem the threat of foreclosure. Second, the Restatement approach affords enormous financial benefits for many homeowners by reducing title insurance premiums. The court looked to a recent law review article explaining how a liberal equitable subrogation doctrine can save billions of dollars by reducing title insurance premiums.

2. JP Morgan Chase Bank v. Howell, 876 N.E. 2d 1171 (Ind. App. Nov. 21, 2007)

The court gave the refinancing mortgagee priority over a junior lienholder based on the doctrine of equitable subrogation. In arriving at its decision, the court relied on the same Restatement approach as relied upon by the court in *Prestance.*

On May 24, 2002, Irwin Mortgage held a first mortgage and Bank of America held a second mortgage against the subject property. On May 24, 2002, Accredited Home Lenders executed and delivered a promissory note in the principal amount of $149,000.00. The note and mortgage were ultimately assigned to Equity One. (For simplicity, Equity One's predecessors in interest are referred to "Equity One"). Equity One used the proceeds of the promissory note to pay off the mortgage of Irwin Mortgage which mortgage was released. Bank One recorded a mortgage in 1999 which secured a revolving line of credit. The Bank One mortgage stated that it may be secondary to the lien securing payment of an existing obligation. The mortgage of Irwin Mortgage was superior to Bank One's mortgage. Equity One did not confirm whether it had satisfied Bank One's mortgage.

Equity One filed a complaint seeking to foreclose its mortgage and a declaration that its mortgage was a valid and enforceable priority lien against the mortgaged property. It contended that it was entitled to equitable subrogation on the following grounds: (1) Equity One refinanced Irwin's mortgage which was senior to Bank One's mortgage (2) Bank One would not be disadvantaged, in that its position as junior lienholder would remain unchanged, and (3) Equity One was not culpably negligent.

The court found that allowing Bank One's lien to take priority over Equity One's lien would result in an unearned windfall to Bank One, which had no notice of the possible existence of a senior lien when it executed and recorded its mortgage. The court stated that "Bank One wisely does not argue that it would be disadvantaged by equitable subrogation" 876 N.E. 2d 1171. Furthermore, the court found that any negligence in Equity One's failure to confirm whether it had fully satisfied Bank One's mortgage did not prejudice Bank One and did not amount to culpable negligence.

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3. UnionBank v. Thrall, 374 Ill. App.3d 785 (2d Dist. 2007)

In 1996, Eureka Savings Bank ("Eureka") recorded mortgages on properties in Sandwich and Somonauk, Illinois. In 1999, Union Bank ("Union") recorded mortgages on the same properties. In 2001, Eureka recorded mortgages on the two properties and released its 1996 mortgages. The trial court found Union Bank's lien to be prior based on the first in time, first in right principle. Eureka contended that its 2001 liens were prior based on conventional subrogation. It contended that its 2001 mortgages were merely replacements of the 1996 mortgages and were entitled to retain the priority of the 1996 mortgages.

The court described the confusion in the case law over the proper scope of conventional subrogation. The term was first used by the Illinois Supreme Court in the late 1800's where it defined conventional subrogation as an "equitable right springing from an express agreement with the debtor, by which one advances money to pay a claim for the security of which there exists a lien, by which agreement he is to have an equal lien to be paid off." However, the Illinois Supreme Court has not used the phrase in the situation in which the original lienor refinances the initial loan and takes a new mortgage in return, but does so intending to maintain its own priority. The Restatement refers to the term as replacement of senior mortgages rather than conventional subrogation. Restatement §7.6 comment e. In *UnionBank,* the court addressed whether the doctrine of conventional subrogation could apply where a lender replaced its own debt.

In applying the doctrine to the case, the court looked to four elements. (1) the refinancing lienor must have intended to retain the priority of his original mortgage; (2) the new mortgage must have been used to pay off the first mortgage (3) the intervening lienor must have been on notice of the original mortgagee's priority at the time he issued the indebtedness secured by the mortgage, and (4) the first mortgage must not have been released prior to the intervening lien. The issue to be determined on remand was whether Eureka intended to retain its priority in 2001 when it refinanced and released the 1996 mortgages.

4. **Ex Parte Lawson v. Brian Homes, 2008 AIG LEXIS 154**

A home building company developed certain parcels of property by building single-family residences on those parcels. On June 20, 2003, the builder obtained a construction loan secured by a mortgage upon those parcels (the senior mortgage). In January 2004, the construction loan secured by the senior mortgage was paid in full with the proceeds of loans made on behalf of the ultimate occupiers of the constructed houses.

A subcontractor of the builder performed work installing carpet, tile, and marble floor in numerous residences. At the time the construction loan was paid in full, no materialman's liens had been recorded. In fact, it was undisputed that the lenders had no notice of a junior or secondary lien at the time they provided the funds to satisfy the loan secured by the senior mortgage. The subcontractor perfected her lien as to the parcels at issue during the Spring of 2004, and in August 2004 she filed multiple actions against the lenders and purchases to enforce those liens.

The subcontractor asserted that her lien took priority over the lenders' mortgages based on Alabama law. The lenders filed summary-judgment motions in each of the actions, arguing that the liens did not have priority over

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the lenders' mortgages or that the lenders' were due to be equitably subrogated as to the senior mortgages.

The court reversed the trial court's entry of summary judgment against the subcontractor. The subcontractor conceded that her materialman's liens were subordinate to the senior mortgage, which financed the builder's construction loan. In order for the lenders who loaned money to the homeowners to purchase their homes to be entitled to equitable subrogation as to the senior mortgage they needed to establish the following elements:

"(1) The money is advanced at the instance of the debtor in order to extinguish a prior encumbrance; (2) the money is used for that purpose with the just expectation on the part of the lender for obtaining security of equal dignity with the prior incumbrance; (3) the whole debt must be paid before subrogation can be enforced; (4) the lender must be ignorant of the intervening lien; and (5) the intervening lienor must not be burdened or embarrassed."

The lenders did not establish the first and fourth elements. The Court found that the money was not advanced at the instance of the debtor in order to extinguish the prior encumbrance because the second loans were not made to the original developer, the original debtor, but were made to the ultimate purchasers. Furthermore, they were not made for the direct purpose of extinguishing a prior encumbrance but for the purpose of enabling the purchasers to make their purchases of the houses.

As to the fourth element, the Court found that the constructive notice supplied by the materialman's lien statute defeats the lenders' equitable subrogation claim. The court found that the statute is an expression of legislative intent that "should stay the hand of equity in this situation."

The Court referred to *Prestance* in arriving at its decision. However, it found that mechanics lien falls with an exception.

Conclusion

Despite an initial resistance to subrogation many courts now apply it liberally. The *Howell* case described equitable subrogation as "a highly favored doctrine, which is to be given a liberal application." While recording acts provide stability and notice to lenders, both vital elements to any successful real estate lending scheme, courts cannot rigidly adhere to their strictures where they work an injustice, *Prestance*, 160 P 3d at 570.

Subrogation reduces title company premiums which benefit the parties to the transaction. It prevents an unearned windfall. However of most significance in these times, if facilitates refinancing of mortgages in order to prevent foreclosure.

Yet as shown by the *Lawson* case, subrogation will not always be recognized. It ultimately depends upon the equities and attending facts and circumstances of each case. ■

Stubborn Sellers Suffer Triple Damages for Bad Faith

by Harris Ominsky, Philadelphia, PA

A recent case illustrates how "playing hardball" in a home sale doesn't get you to home base. In addition, you can lose not only the game, but also both the ball and the bat.

In the case of *Schaumberg v. Friedmann*, No. 06-P-1841 (Mass. App. 06/13/2008), the Appeals Court of Massachusetts awarded buyers triple damages against a seller for inspection and appraisal fees, as well as reimbursement of attorney's fees incurred in a dispute over the return of a $100,000 deposit. Under what appears to be a customary agreement of sale the buyer had the right to a return of the deposit if the seller could not deliver "good, clear and marketable title free from encumbrances."

Closing Problems

Right before the scheduled closing, the buyers learned that their lender's title insurance company had discovered potential serious issues with title. The buyers then requested an extension of the closing date, which the seller refused. The title search had disclosed a number of encumbrances, including a petition to foreclose a tax lien and writs of attachment. The seller argued that the encumbrances were "invalid." In addition, the deed purported to convey title from a partnership in which the seller was not the named general partner and the seller failed to present a partnership agreement or a power of attorney authorizing him to convey title on behalf of the partnership

Seller's Tactics.

According to the court, the tenor of the closing rapidly deteriorated. Although the seller offered to place the sale proceeds in an escrow account until the title issues were resolved, the buyers declined the offer because the amount needed to cure the encumbrances was unknown and they were uncertain whether the defendant had authority to act on behalf of the partnership. Furthermore, as the trial judge noted, the defendant made this and other offers in a "hostile, sometimes threatening and irregular manner."

After the parties left the scheduled closing with the issues still unresolved, the parties had an exchange of correspondence in which the seller threatened to forfeit the deposit as liquidated damages and suggested that the buyers' attorney was guilty of malpractice. He refused to carry out the transaction until the buyers had engaged new counsel and met "a few conditions." In addition, the seller refused to participate in clearing any of the title defects and persistently failed to show that he was authorized to convey title. He also refused to complete the sale unless the buyers obtained financing from a different lender.

Shortly thereafter, the buyers' counsel notified the seller of an additional closing date, but the seller stated that he would not attend and that the buyers would have to sign a new purchase agreement if they wanted a deal to go through. He also refused to sign a release authorizing the escrow agent to release the deposit to the buyers.

Bad-Faith Breach

Based on these facts, the trial judge concluded that the seller had breached the agreement by failing to provide proper title and to authorize the return of the deposit to the buyers. The judge also determined that the seller's actions, including threatening suit against the buyers and their representatives

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were “a knowing, willful violation of G.L. c. 93A.” This is a Massachusetts consumer protection act that permits an award of triple damages under certain circumstances.

The court held that the seller had repeatedly made demands to the buyers outside the scope of the original agreement and threatened to keep the deposit as leverage to re-negotiate the original agreement for greater personal gain. These actions were a knowing, willful violation of contractual obligations taken for the purpose of securing unwarranted benefits from the buyers in violation of that consumer Act. Further, the judge ruled that the seller’s conduct was unreasonable and a bad faith violation of the Act.

As a result, the judge ordered that the escrow money be returned to the buyers together with interest at the rate of 12%, and awarded a reimbursement of $58,000 of attorney’s fees, as well triple damages for inspection and appraisal fees incurred by the buyers. Therefore, in addition to the return of the deposit, the award amounted to over $78,000. Also, the judge awarded payment of the buyers’ attorney’s fees incurred in the appeal.

The seller argued that even if he did commit a breach of the agreement, the consumer protection act should not apply because every breach of contract is not a violation of that Act. The Court responded that nothing on the record of the case supports the seller’s contention that there was a “good faith dispute [that] money was owed, or a performance of some kind” was due from the buyers. There was no real “genuine difference of opinion” in this case about the issues in dispute. Also, there is no good faith justification for the seller’s refusal to authorize the return of the deposit.

<u>Consumer Protection Laws</u>

The seller also tried to avoid the long arm of the Act by claiming that he was not engaged in “trade or commerce” to which the Act was intended to apply. The Court responded that the seller, who routinely purchased and sold residential property, operated under a company name, and never lived in the property that he had purchased as an investment. Also, during a period of several years, he had sold seven other investment properties in Cambridge alone. Therefore, the sale at issue in this case was a routine business transaction.

In answer to the seller’s complaint that the award of attorney’s fees was excessive, the Court pointed out that the trial judge could have classified those fees, not merely as attorney’s fees, but also as “reliance damages” which could have been tripled under the Act to award an additional $116,000. In effect, the trial court had given the seller a break by not using that classification.

Pennsylvania and many other states have consumer protection laws, including unfair practices acts that take violators to task by awarding treble damages for various unfair business practices. The *Schaumberg* case may be viewed as a reminder to consumers’ attorneys that they may be able to hit a triple, or even a home run, when dealing with unscrupulous or unreasonable conduct from business people who sell or lease property on a regular basis. The threat of having to pay triple damages for being unreasonable has a way of making intransigent people start thinking reasonably. In addition, the *Schaumberg* case serves as a warning to those clients and their attorneys who sometimes think that playing hardball in a consumer transaction is a winning game. ■

Closing Protection Letters: What Is (And Is Not) Covered

by John C. Murray, First American Title Insurance Company, Chicago, IL © 2008

Introduction

Title agents are customarily authorized, through agency agreements, to sell policies for one or more title insurance underwriters. These agency agreements normally provide that the agent is an agent solely for the purpose of issuing title insurance commitments and policies, and explicitly state that the agent is not the title company's agent for the purpose of conducting settlements or performing escrow services. Authorized title agents also often act separately as the agent for the lender, buyer and/or seller, pursuant to instructions from such "principals" (that only such principals can enforce), in connection with the escrow closing of the transaction that is the subject of the title insurance. A lender who also wants the title insurer to be responsible for the agent's acts in connection with escrow closing activities and services must separately contract with the title insurer for such additional protection by entering into an "insured closing letter" or "closing protection letter" ("CPL"). CPLs have been available since the 1960s. They originally were not title-industry approved forms but, rather, were forms requested by mortgage lenders that were concerned they had no protection against unauthorized or fraudulent actions, or failure to comply with the lender's closing instructions, by the title company's approved closing agent or attorney. Lenders require CPLs because the agency-principal relationship between a title underwriter and a policy-issuing agent or approved attorney is limited to the issuance of a title-insurance policy, and such relationship does not extend to escrow or closing functions.

CPLs – What is Covered?

CPLs specifically apply to escrow closing activities and services performed for title underwriters by approved attorneys or agents who are not employees of the title companies; as a general rule they are not issued on behalf of independent closers over whom the title company has no control. (An "Approved Attorney" is defined in the standard forms of CPLs as "an attorney upon whose certification of title the title insurance company issues title insurance"; an "Issuing Agent" is defined as "an agent authorized to issue title insurance for the title insurance company"). These letters are standardized indemnity agreements given to individually named lenders and recite the specific conditions under, and the extent to which, title insurers will accept liability for the acts or omissions of such parties.

A CPL generally applies only with respect to the particular transaction for which it is issued, although title insurers generally also will issue a general or "blanket" CPL that protects a particular lender in connection with escrow closing activities and services involving a designated agent for a specified period of time. The CPL specifically provides that the title insurance company will reimburse the customer named in the letter (when the customer is purchasing the title company's policy) for losses incurred under certain conditions and as the result of certain actions or inactions by the approved agent or attorney. The CPL further provides that the customer's recourse against the title insurer is limited to and defined by the provisions of the letter with

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respect to such losses. *See Metmor Financial, Inc. v. Commonwealth Land Title Ins. Co.*, 645 So. 2d 295, 297 (Ala. 1993) ("The purpose of the closing service letter is to provide indemnity against loss due to a closing attorney's defalcation or failure to follow a lender's closing instructions").

CPLs are intended to indemnify lenders solely against losses incurred as the result of (1) dishonesty or fraud by the Issuing Agent or Approved Attorney in handling the lender's funds or documents in connection with the specific transaction for which the letter is issued (the 2008 ALTA CPLs, described below, now provide this specific coverage only to the extent that fraud, dishonesty or negligence relates to the status of the title to the interest in the land being insured or to the validity, enforceability, and priority of the lien of the mortgage on that interest in land), and (2) failure of the Issuing Agent or Approved Attorney to comply with the written closing instructions of the lender to the extent they relate to status of title to the lender's interest in the land or the validity, priority or enforceability of the mortgage on the land, including the obtaining of documents and disbursement of funds in connection therewith (although not to the extent such instructions require a determination of the validity, enforceability or effectiveness of any such document). CPLs do not, however, provide coverage for such matters as failure of the documents to comply with applicable laws or regulations (including environmental, land use, lender regulation, and zoning) or facts and circumstances regarding the closing or the parties to the closing.

In October 2007, the ALTA Forms Committee adopted three new CPL forms ("2008 ALTA CPLs"), which were designed to replace their predecessor 1998 forms. These forms were introduced as official ALTA Forms on January 1, 2008, after the ALTA Forms Committee considered comments from several interested groups and organizations. The number of ALTA CPL forms available is now limited to these three new forms, and the substantive changes are the same in each of the 2008 ALTA CPLs. Adverse claims experience may have prompted the changes made in the 2008 ALTA CPLs, as ALTA has "tightened up" the former CPL forms with respect to affirmative coverage and has included additional conditions and exclusions. All three new 2008 ALTA CPLs adopt the concept of the ALTA Regulatory closing protection letter as set forth in an Administrative Letter issued in 1995 by the Commissioner of Insurance of the Commonwealth of Virginia, to all companies licensed to write title insurance in Virginia ("Virginia CPL Letter"), i.e., limiting the issuer's liability for fraud, dishonesty or negligence solely to losses relating to the status of title or the insured mortgage. The Virginia CPL Letter advises title insurers licensed in Virginia that by statute they are single-line (or "monoline") insurance companies and that CPLs (whether on an individual or blanket basis) may not be used to indemnify lenders for losses that are unrelated to the condition of title to the property or the status of any lien on the property.

All three new 2008 ALTA CPLs specify the nature of the relationship between the issuer and the agent or approved attorney and disclaim liability for the acts or knowledge of other third parties and for the economics of the transaction. Also, all three new forms include an arbitration clause that parallels the arbitration clause in the 2006 ALTA Owner's and Loan Policies. These new forms are available on the ALTA website: http://www.alta.org/.

Even though the 2008 ALTA CPLs became effective on January 1, 2008, the ALTA Forms Committee will be reviewing

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comments and suggestions submitted by interested individuals and groups since October 2007, at its next meeting in 2008 and will, among other things, decide whether to make any further changes based on those specific comments and suggestions.

Statutory and Regulatory Restrictions

Although the ALTA forms of CPLs generally are used in most states, some states restrict, limit, or prohibit their use. The principal statutory and regulatory rationale for prohibiting or restricting the use of CPLs by title insurance companies has been that their issuance results in the unauthorized writing of fidelity or surety coverage. The issuance of such coverage also may violate the monoline nature and scope of the title insurer's business activities that are authorized by applicable state statutory or regulatory provisions (or the title company's charter).

Most states, however, do not have promulgated or filed CPLs and permit the use of the approved ALTA forms. State regulators in these states generally take the position that the issuance of CPLs, which assure as to certain actions of the title insurer's own policy-issuing agent or approved attorney, do not violate the state's monoline statute so long as a policy is being issued in connection with the subject transaction.

Conclusion

The CPL serves to extend the liability of the (generally) large and creditworthy title insurance company - which would otherwise be limited to the title insurance policy - to cover certain "bad acts" of the company's Issuing Agent or Approved Attorney. But this additional protection must be separately and specifically requested from the title insurer, and the scope of the coverage is defined solely by the terms and provisions of the letter. Coverage under the CPL is also strictly limited to the parties designated therein, and generally applies only with respect to the particular transaction for which the letter is furnished. The ALTA has attempted to meet the needs of title insurance customers by expanding the types of CPLs (the latest being the 2008 ALTA CPLs) to cover varying factual situations and comply with state statutory and regulatory restrictions. It is important for both the insured and the insurer to understand the legal (both case law and statutory) and regulatory restrictions and limitations on the use of CPLs in certain jurisdictions, and the nature and scope of the agency relationships that exist between title insurance companies and their Issuing Agents and Approved Attorneys. Recently, some title insurers have been pressured to issue CPLs to parties other than Issuing Agents and Approved Attorneys, such as independent escrow or settlement-service companies, real estate brokers, and loan originators in securitized and conduit transactions. It is likely that title companies will strongly resist such efforts because of the very real risk of incurring liability without accountability and supervision, and because of the additional risk of providing unauthorized fidelity or surety coverage. ■

ACRELades

Douglas M. Bregman was named the recipient of Georgetown University Law Center's Charles Fahy Distinguished Adjunct Professor of the Year Award. The award is given to those professors who have provided exceptional service to Georgetown in teaching, curriculum development, student counseling and involvement in extra-curricular Law Center activities.

The Greater Kentucky Chapter of the March of Dimes has presented **Alfred S. Joseph, III,** with the 2008 Commercial REACH Award at a breakfast at Churchill Downs. The award recognizes his contributions to commercial real estate and to the community.

Kenton Kuehnle has received the Robert L. Hausser Memorial Award from the Ohio State Bar Association Real Property Section. The award recognizes outstanding achievement, contribution and leadership in the practice of real property law.

Meetings Calendar

2009 Mid-Year Meeting
March 26-29, 2009
Wyndham Rio Mar
Rio Grande, Puerto Rico

2009 Annual Meeting
October 29-November 1, 2009
JW Marriott
Washington, DC

2010 Mid-Year Meeting
March 11-14, 2010
Terranea Resort
Palos Verdes, CA

2010 Annual Meeting
October 7-10, 2010
Four Seasons
Toronto, Canada