ACREL

News

President's Message

It has been an interesting and challenging year, and my tenure as President is drawing to a close. We have just returned from an extremely successful Fall meeting in Washington, D.C. Over 280 of our Fellows attended, and I would like to extend special thanks to Julian Rackow and the Meetings Committee and to Meg Meister and the Programs Committee for organizing and running a truly outstanding meeting. As always, of course, thanks to Jill and Henri for their outstanding services. The meeting started with a delayed but extremely interesting presentation by Professor Richard J. Herring from the Wharton School, and many thanks to Georgette Chapman Phillips for helping organize a truly outstanding presentation. We had interesting and informative programs on Receiverships, Fannie Mae Financing Guidelines, Where the Real Estate Market is Now (from the Counselors of Real Estate), Green Leasing, and at the end of the program the highly popular Professor's Corner was reprised. On Saturday, after informative sessions on Workouts, we tried a new approach, breaking into four separate concurrent sessions each of which was a presentation by an ACREL Substantive Committee (Title Insurance, Leasing, Common Interest Ownership, and Capital Markets and Finance). We are very interested in your feedback as to whether you liked this format and wish us to repeat it in the future, so please let me, Kevin Shepherd, or Meg Meister know your feedback in this regard. Finally, we concluded with the usual array of excellent workshops.

Saturday night's reception was theme based upon Halloween and there were a great number of very interesting and innovative costumes. Please look for the posting of photographs on the ACREL website – you will be sure to enjoy them.

We had a very successful meeting of the Board of Governors in Washington, and two new initiatives are especially worth mentioning. First, Ann Saegert and Earl Segal spent a considerable amount of time and effort reviewing potential advertising and sponsorship revenue sources for ACREL. The Board will be reviewing these possibilities going forward. Although there may be some opportunities for enhanced revenue, the consensus of the Board is that we will do nothing

continued on page 2

IN THIS ISSUE

President's Message

continued from page 1

that would have an adverse impact on ACREL's unique culture, especially our collegiality, our meetings, and our programs.

Linda Striefsky chaired a task force to examine the impact of changes in the practice of real estate law upon ACREL and she and her group have produced an excellent report which will serve as a guide for continued action by a larger task force during the coming year. While the report notes our Fellows' general satisfaction with the collegiality and overall course of the College, there are a number of areas that we will take a look at to further enhance the value of the College to its Fellows, including examining ways to increase our recognition in the legal profession and the broader business community. We will also be examining ways to contain meeting costs in response to feedback from many of the Fellows.

It has been a very rewarding year for me and I have enjoyed the opportunity to serve as your President. ACREL will be well led in the coming year as Kevin Shepherd commences his term as President – with Kevin, the balance of the Executive Committee, and an outstanding Board of Governors, the College could not be in better hands. Thanks to each of you for your support during the past year, and I look forward to our continued fellowship.

Best regards.

Phil

Philip D. Weller, President

STAFF BOX

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

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

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

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

Deeds in Lieu of Foreclosure – Title Insurance Issues

by John C. Murray, First American Title Insurance Company, Chicago, IL ©2009

Introduction

A deed in lieu of foreclosure has been described as "a transaction in which a borrower, *after default*, conveys to its lender by *absolute* deed title to real property pledged as security for the indebtedness. The consideration for this conveyance consists of relieving the borrower of all *in personam* liability for the loan." *Morrow Dev. Corp. v. Gordon Management, Inc.*, 875 P.2d 411, 413 n.3 (Okla. 1994) (emphasis in text). Lenders often are willing to accept deeds in lieu of foreclosure (especially in these difficult economic times) in connection with loan workouts of residential, agricultural and commercial properties. Deeds-in-lieu (and deeds-in-escrow) also are often done in connection with bankruptcy workouts and "prepackaged" bankruptcy plans. Because a deed in lieu of foreclosure cuts off the borrower's right of redemption prior to foreclosure, the mortgagor may claim that the transaction constitutes an impermissible "clog" of its right of redemption. But because a deed in lieu of foreclosure is subsequent to the original mortgage, and because it is a voluntary conveyance for independent and valuable consideration and serves the socially useful purpose of allowing the mortgagor to avoid a time-consuming, costly, and public foreclosure -- and allows the mortgagor to avoid personal liability on the debt -- an arms-length, fully documented deed-in-lieu transaction should survive a clogging challenge. This article will explore this issue and other issues currently faced by both lenders and title insurance companies in connection with deed-in-lieu transactions.

Concerns (and Requirements) of Lenders and Title Insurers

Lenders and title companies generally share the same concerns about deeds-in-lieu: recharacterization as an equitable mortgage; violation of the "clogging the equity" doctrine (i.e., as noted above, the use of a deed-in-lieu as a means of preventing the borrower from exercising its statutory and/or equitable rights to redeem the property from a foreclosure sale); and setting aside of the transaction as a fraudulent conveyance or preferential transfer under federal bankruptcy or state fraudulent-transfer laws.

Most lenders will not accept a deed-in-lieu unless there are no other mortgage liens or encumbrances on the property and an appraisal (which, depending on the lender's and/or title insurer's underwriting requirements, may be either internal or external) has established that there is no equity in the property (i.e., the amount of the outstanding indebtedness clearly exceeds the current appraised value of the property). The title insurance company will want to obtain a copy of the appraisal showing that the value of the property being transferred is less than the debt ---usually by a factor of at least 10-20%. (The title insurer usually will, upon request, supply the lender with a confidentiality letter with respect to the appraisal.)

Most sophisticated lenders have a specific procedure for deeds-in-lieu, including a settlement agreement, deed with non-merger language, assignments, estoppels, etc. The title insurance company will want to receive and review these documents well in advance of the scheduled closing to make sure they comply in all respects with applicable law and the title insurer's internal underwriting requirements. Many lenders will not cancel the note, but will instead give the borrower a "covenant not to sue." Consideration for a deed-in-lieu transaction can be either release of the borrower of personal liability or, in connection with a non-recourse loan, forbearance by the lender from exercising or activating its statutory and contractual legal rights and remedies, such as foreclosure and assignment of rents. The lender usually will keep the mortgage of record and not discharge or release it until the property is subsequently resold,

continued on page 4

Deeds in Lieu of Foreclosure...

continued from page 2

or the mortgagee records a release or discharge of the mortgage. As mentioned above, the lender may give the mortgagor a covenant not to sue, as opposed to cancellation of the note, and will keep the mortgage of record when obtaining a deed-in-lieu in connection with a workout of a defaulted mortgage loan, in order to: (i) provide consideration for the transaction; (ii) maintain priority over subordinate liens and the ability to subsequently foreclose its mortgage to eliminate subordinate lien and encumbrances; (iii) preserve its first lien interest if the deed-in-lieu transaction is subsequently set aside as the result of a fraudulent-conveyance or preferential-transfer action by a bankruptcy trustee or other creditors of the mortgagor, or as the result of any state-court action; and (iv) avoid a subsequent argument by the mortgagor or another creditor that the mortgage has in fact been discharged and is void because the note evidencing the underlying indebtedness has been canceled or extinguished.

The validity of attempting to preserve the mortgage lien may depend on whether other creditors would be prohibited from availing themselves of the normal methods of collection that they would otherwise have if the lien were extinguished, and will also depend to a great extent on the intention of the parties as stated in the settlement agreement and the deed. Most states, including Illinois, will enforce such a stated intention.

Where available, and based on applicable law and facts, (and the circumstances of transaction), the title insurer may be willing to issue non-merger endorsement to the Loan Policy, insuring that the mortgage will not be deemed invalid or unenforceable by virtue of title to the property becoming vested in the lender. Recent case law generally supports the ability of a mortgagee to foreclose its mortgage after acceptance of a deed in lieu of foreclosure, at least where the settlement agreement and deed contain an anti-merger provision. *See* John C. Murray, *Deeds in Lieu – Subsequent Foreclosure of Mortgage* (2009), available at http://www.firstam.com/listshortcut.cfm?id=3248&menu=676. Courts may not be willing to enforce a non-merger provision in a deed in lieu of foreclosure where rights of innocent third parties may be affected – or even lost – because of fraud or inequitable conduct by parties to deed. (But this is rare and applies only in very complicated and unique factual situations.)

Importance of Obtaining Owner's Policy

Lenders usually will (and certainly should) obtain a new Owner's Policy of title insurance upon completion of the deed-in-lieu transaction, rather than rely on continuation of the coverage under the existing Loan Policy (although the Loan Policy should be downdated if the parties express their written intention to keep the mortgage alive and the applicable jurisdiction enforces such intention). This is so because the Loan Policy only covers matters of record at the time of the original loan; it does not insure the validity of the deed-in-lieu transaction or provide coverage for creditors' rights issues in connection with the transfer of title; and it provides different claim coverage than a new Owner's Policy (i.e., unlike an Owner's Policy, which provides for payment upon proof of loss because of the diminution in value of the estate caused by the title defect, a lender insured under a Loan Policy must first establish that a loan default and an actual impairment of its security as a result of foreclosure have occurred as a result of the defect before it will be entitled to recover under the Loan Policy).

Section 2 (Continuation of Insurance) of the 1992 ALTA Loan Policy contains a provision (sec. 2.a.) that provides for continuation of coverage only if the insured acquires the land by "conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage," but this specific requirement has been eliminated in the new 2006 Loan Policy, which policy is discussed below. *See* Janice E. Carpi, *Title Insurance Following Foreclosure, Beyond the Workout: Risks for Lenders Taking Back and Owning Real Estate*, Third Annual Spring CLE and Committee Meeting, Real Property Law Programs, American Bar Association, Section of

continued on page 5

continued from page 3

Real Property, Probate and Trust Law, New York, NY (May 7-9, 1992) at A-3. The lender may, in addition to obtaining a new Owner's Policy in connection with a deed-in-lieu transaction, request certain endorsements to the existing Loan Policy such as a non-merger endorsement (discussed above) and an endorsement insuring the continuing validity, enforceability and priority of the mortgage lien upon consummation of the deed-in-lieu transaction.

Creditors' Rights Coverage

Title insurers sometimes are requested to provide affirmative insurance against creditors' rights' claims in deed-in-lieu transactions. Lenders considering such transactions outside of bankruptcy may seek to obtain affirmative creditors' rights coverage because of the risk of a fraudulent-conveyance or preferential-transfer claim in a subsequent bankruptcy proceeding by or against the debtor. But such coverage is not "standard" or the "norm" (especially in the current economic environment) and would be available only on a case-by-case basis after carefully underwriting the transaction and tailoring such coverage to cover only certain risks. This may involve significant due diligence on the part of the title company and will, in any event, require strict compliance with the internal requirements of title insurers with respect to creditors' rights coverage.

On April 19, 2004, the ALTA adopted Endorsement Form 21, which insures against loss under an Owner's or Loan Policy because of the occurrence, on or before the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law or state insolvency or creditors' rights laws. It also confirms that title insurers will pay all costs, expenses and attorneys' fees to defend the insured against such claims. It expressly excludes coverage for such loss, however, if the insured knew that the transfer was fraudulent or was not a purchaser in good faith. The benefit of this endorsement is that it expressly provides affirmative coverage, so that the insured no longer has to request the removal of the existing policy exclusion for creditors' rights issues, or require a pre-1990 policy that did not contain the exclusion -- and then wonder if the insuring provisions of the policy (without the exclusion) provided coverage for creditors' rights matters. The Endorsement Form 21 may be issued only if, after thoroughly reviewing the transaction and chain of title (and perhaps certain off-record issues), the title insurer is satisfied that no creditors' rights issues exist.

The American Land Title Association ("ALTA") Forms Committee revised the standard, or "base," 1992 ALTA Owner's and Loan Policy forms and a number of related forms. These new forms were formally adopted by the ALTA Board of Governors at its meeting on June 17, 2006 and have been approved for use in almost all of the states. New Covered Risk 9(a) (Owner's Policy) and new Covered Risk 13(a) (Loan Policy) provide coverage for creditors' rights issues in the "past chain of title" (i.e., any fraudulent or preferential transfer prior to the transaction vesting title (Owner's) or creating the lien of the insured mortgage (Loan).

New Covered Risk 9(b) (Owner's Policy) and new Covered Risk 13(b) (Loan Policy) provide coverage for "preferences" resulting solely from the failure to timely record the transfer instrument or the security instrument or of the recording of the instrument to impart constructive notice to and bind third parties. Any other cause of a preferential transfer challenge arising out of the insured transfer is excluded from coverage by Exclusion 4(b) (Owner's Policy) and Exclusion 6(b) (Loan Policy)

Covered Risk 13 should be read very carefully. Section 13(a) of the 2006 Loan Policy insures against "The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage" resulting from a *prior transfer* constituting a fraudulent or preferential transfer, but does not cover that risk for the "transaction creating the lien of the Insured Mortgage." (Emphasis added.) Covered Risk 13(b) does give some limited coverage with respect to preferences for the

continued on page 6

continued from page 5

insured mortgage itself.

Exclusion 6 of the 2006 Loan Policy makes it clear that it only applies to those creditors rights' issues affecting "the transaction creating the lien of the Insured Mortgage" that are not stated in Covered Risk 13(b).

To fill the "gap" created by Covered Risk 13(a) and Exclusion 6, the insured may request the ALTA Endorsement Form 21 (Creditors' Rights Endorsement) with respect to a deed-in-lieu transaction, where available based on the jurisdiction, the facts of the transaction, and strict compliance with title-company underwriting requirements.

The creditors' rights Exclusions (and applicable Covered Risks) in the 2006 Owner's and Loan Policy forms, respectively, read as follows:

Owner's Policy (Paragraph 4 of Exclusions from Coverage)

> Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction vesting the Title as shown in Schedule A, is
> (a) a fraudulent conveyance or fraudulent transfer; or
> (b) a preferential transfer for any reason not stated in Covered Risk 9 of this policy.

Owner's Policy (Paragraph 9 of Covered Risks)

> Title being vested other than as stated in Schedule A or being defective
>
> (a) as a result of the avoidance in whole or in part, or from a court order providing an alternative remedy, of a transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction vesting Title as shown in Schedule A because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws; or
> (b) because the instrument of transfer vesting Title as shown in Schedule A constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records
> (i) to be timely, or
> (ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

Loan Policy (Paragraph 6 of Exclusions from Coverage)

Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction creating the lien of the Insured Mortgage, is

(a) a fraudulent conveyance or fraudulent transfer, or
(b) a preferential transfer for any reason not stated in Covered Risk 13(b) of this policy.

Loan Policy (Paragraph 13 of Covered Risks)

The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage upon the Title

(a) resulting from the avoidance in whole or in part, or from a court order providing an alternative remedy, of any transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction creating the lien of the Insured Mortgage because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or

continued on page 7

continued from page 6

similar creditors' rights laws; or
(b) because the Insured Mortgage constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records
(i) to be timely, or
(ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

A request to provide creditors' rights coverage places additional burdens on the title insurer, which may seek to be compensated for the additional risk by charging an additional risk premium for the endorsement. Normally, in a deed-in-lieu transaction, reasonably equivalent value will have been given for the deed because the value of the property will have been established by appraisal (supplied to the title insurer) to be less than the amount of the outstanding mortgage debt (usually not a problem in the current depressed real-estate market).

Where a creditors' rights issue has been identified because a transfer is being made without the transferor receiving reasonably equivalent value, the primary basis for underwriting the risk involves engaging in credit and finance underwriting. This is a significantly different approach to underwriting than what most underwriters are accustomed to, or prepared for, because it focuses on issues other than real estate. In such a situation, the title insurer probably would not be comfortable issuing affirmative creditors' rights coverage for the transaction, as it would need to conduct significant additional due diligence (of non-title-related matters) with respect to underwriting the transaction, including a detailed analysis of the following: the transferor's business and its financial statements; its payment history and ability to pay its business and trade debts as they are incurred; its capitalization both before and after the transfer; the amount of secured and unsecured credit obtained by the transferor both before and after the transfer; the incurrence of any large or unusual debt obligations, and a determination of whether the delivery of the deed-in-lieu will render the borrower insolvent. Even if the title insurer still could be persuaded to issue creditors' rights coverage in such a situation, it may need to tailor the coverage to the particular fact situation and may charge a significant additional risk premium to cover its potential liability.

The legal costs of defending an action based on a creditors' rights claim may be substantial even if the title insurer ultimately prevails on the merits. If the facts of the transaction so warrant, the title company may refuse to provide coverage, or may require that an independent third party with a demonstrated and substantial net worth indemnify the title insurer, at least for the costs of defense of any such claim (with, perhaps, the furnishing of security for such indemnity). Obviously, a "going concern" business (as would be the case with an entity that conducts a manufacturing or service operation) would require more due diligence than the typical passive real-estate bankruptcy-remote single-purpose borrowing entity (such as a limited liability company, limited partnership, or business trust) that has no personal liability for the mortgage debt and merely serves merely as an investment conduit vehicle for the equity holders.

The title insurer must also be careful, when issuing affirmative coverage for creditors' rights issues, to provide insurance only for the specific risks that it feels comfortable that it can assume after conducting its due diligence. For example, the title company may agree to provide affirmative coverage against a claim alleging that the transaction constitutes a fraudulent conveyance or preferential transfer. [Note: the coverage of equitable-subordination claims has been eliminated from the ALTA 2006 Owner's and Loan Policies, as this was deemed by the ALTA to be a matter within the control of the insured]. The title insurer will in any event – and justifiably -- specifically exclude coverage for any deliberate "bad acts" of the insured, i.e., any transfer or conveyance that the insured knew, at the time it acquired any estate or interest in the subject property, was actually intended to hinder, delay or defraud any creditor,

continued on page 8

continued from page 7

or where the insured is found by a court not to have been a transferee or purchaser in good faith.

Recharacterization Risk – Equitable Mortgage

Generally, no continuing, contingent, or residual rights (including an option to purchase, right-of-first refusal, continued possession, or even a long-term lease) should be given to the mortgagor-grantor in connection with a deed-in-lieu, as a court may construe the proposed transaction as an equitable mortgage and the title insurer may refuse to provide coverage against any such recharacterization. The parties' intention to actually create an equitable mortgage instead of a deed of conveyance may be shown by:

- The statements of the parties.
- The existence of a substantial disparity between the value received by the grantor and the actual value of the real property at the time of conveyance.
- The fact that the grantor retained possession of the real property.
- The fact that the grantor continued to pay real estate taxes and other property expenses.
- The fact that the grantor made improvements to the real estate subsequent to the conveyance.
- The nature of the parties to the transaction and their relationship both prior to and after the conveyance.
- The fact that a contingency exists or a subsequent event could occur that would "unwind" the transaction or cause the mortgagor (or guarantors) to again become liable for all or a portion of the debt.

Other Issues

If the conveyance of the deed-in-lieu is not to the lender, but instead to a subsidiary of the lender or a special purpose entity created by the lender, the title insurer will probably have no problem insuring the transaction, as long as the lender owns 100% of the entity actually taking title and the deed contains typical non-merger language to keep the mortgage alive.

If the deed-in-lieu documentation (including a covenant not to sue, as described earlier in this article) contains a "reinstatement" or "unwind" provision that could place the respective parties back in their original positions if there is a subsequent successful challenge to the validity of the deed-in-lieu transaction, such a provision may (depending on the facts) cause the title insurer to raise an exception to the provision because of the risk of a total failure of title under the Owner's Policy issued to the lender.

Conclusion

A deed in lieu of foreclosure is a complex legal transaction. Attorneys for both the lender and the borrower should carefully consider the practical, legal, title, and tax aspects of a deed in lieu of foreclosure. A voluntary conveyance may benefit either or both parties. Both sides of the transaction should carefully draft and document all phases of the conveyance to avoid unintended and undesirable legal and economic consequences. Also, it is important that the lender contact the title insurer at the commencement of the transaction in order to make certain that all applicable underwriting requirements are understood and complied with and that proper title coverages and endorsements (where applicable and available) are obtained. ■

A Lender's Primer: Major Repair Loans for Condominiums and Other Common Ownership Communities*

by Richard A. Rosner, Taft Stettinius & Hollister LLP, Cleveland, OH

The condominium form of ownership in the United States is the product of enabling legislation enacted the last half of the 20th century. Many condominiums and other common ownership communities may be facing major repairs, replacements and renovations. Providing for such major repairs is more acute if a building was constructed as a rental apartment building and converted to a condominium form of ownership after the adoption of a condominium statute. In such a case, the building most likely will be more than a half century old. This article deals with sources for funding the major repairs with emphasis on loans to associations to finance these repairs.

1. **Funding Major Repairs Through Reserves.** The ideal source for funding major repairs is from adequate repair and replacement reserves built up by the association over the years. Even if the governing documents mandate the establishment of reserves (a requirement of the Federal National Mortgage Association Guidelines), the requirement does not guarantee that the reserves will be adequate to fund major repairs. The association's board of directors or the association's management company should budget for the cost of the major repairs based on realistic cost estimates updated on a current basis. The board may consider engaging a consultant that specializes in representing associations in the budgeting of major repairs. Even with careful planning, however, the reserves may be inadequate if major structural components (roads, bulkheads, foundations or roofs, among others) need replacement before the projected expiration of their estimated remaining useful life, or if an unexpected major expenditure was not included in the budget (installing bulkheads resulting from erosion, for example, or unstable waterfront soils conditions). Other options, therefore, need to be considered.

2. **Funding Major Repairs Through Cash Payments or Individual Loans.** Another source of funding major repairs is the imposition of a one-time cash assessment that would force all property owners in the community to pay a proportionate share of the expenses. A substantial cash assessment, however, could result in a tremendous hardship on homeowners who do not have the financial wherewithal to pay their share. An assessment also could create divisiveness among the homeowners and could, ultimately, result in homes being placed for sale at below market prices and a general decline in the value of homes within the community.

To address some of these problems, homeowners could be given the opportunity to pay the assessment over time. The association could arrange individual loans for homeowners, as opposed to the association obtaining a loan, or the homeowner could arrange for his or her own financing. If the association arranges for the homeowner to obtain a loan, the homeowner would sign an interest-bearing promissory note that may or may not be secured by a mortgage on the owner's home. The note and mortgage could run in favor of the association, which, in turn, could assign the same to the lender as security for a loan obtained by the association from the lender.

Alternatively, the association could levy a special assessment for the major repairs and file a lien against each homeowner who does not pay the assessment within the payment period specified in the governing documents (30 days, for example). The lien could then be assigned by the association as collateral for a loan from a financial institution. However, this alternative is not desirable to all homeowners, because it may violate a loan covenant contained in the home-

*Reprinted with permission from the Probate & Property magazine of the ABA, March/April 2005

continued on page 10

continued from page 9

owner's first mortgage prohibiting involuntary liens and, in addition, may have an adverse effect on the homeowner's credit.

3. **Funding Major Repairs Through Financing Obtained by the Association.** The third source of funding, and the primary focus of this article, is for the association to obtain a loan on behalf of some or all of the unit owners to fund major repairs. Not surprisingly, few lenders are familiar with this type of loan, and they need to become comfortable with its mechanics and underwriting.

A. **Amount of Loan.** After the association's board of directors determines what major repairs are needed, the board must determine the anticipated costs. The association, acting through its board of directors or a board-appointed committee or the association's management company, should retain the services of engineering and/or architectural firms to determine the scope of the work needed, prepare specifications, and estimate the cost of the project. The association should then obtain bids from reputable contractors for performing the major repairs.

Because the board of directors owes a fiduciary duty to the association's members (the homeowners), it highly recommended that the bid specifications require a guaranteed maximum construction price and obligate the contractor to post a performance bond or other adequate security to assure lien-free completion of the major repairs. The use of a performance bond will also enhance the association's ability to obtain favorable financing. Incidentally, this procedure should be followed whether or not the association intends to finance the cost of the major repairs.

After the board of directors has determined the need and cost of the major repairs, it should make an application to a lender to obtain a loan commitment to fund the repairs. The board should determine the portion of the cost that is to be funded from cash reserves and/or by a direct payment from homeowners to the association, and how much will be financed. The lender will typically require a portion, usually at least 25%, of the cost of the project to be funded in cash by the association.

ii. **Authority for Loan.** Concurrently with the board of directors' determining that a loan is necessary, the directors should also ascertain if they have the authority to authorize the major repairs and obtain the financing. Typically, the board has the authority on its own to make repairs and replacements, but not the authority to make capital additions or improvements over a threshold amount. The latter generally requires the vote of a percentage of homeowners as specified in the declaration or other governing documents (typically, a majority of the voting power of the association). The governing documents will need to be reviewed to determine if the board has the authority to borrow funds to pay for the major repairs. A situation may exist in which the board has authority to make major repairs, but does not have authority to borrow funds.

If the major repairs are substantial or if capital additions or improvements are proposed along with the major repairs, or if the board is unsure if the work should be classified as major repairs or as major improvements, it is strongly recommended that homeowner as well as board authorization be obtained. Sometimes, it is unclear whether the proposed work constitutes a replacement or improvement. For example, courts have held replacing windows with identical windows is a replacement, but replacing windows with a different type of a window (replacing single pane windows with double pane windows, for example) would constitute an improvement requiring homeowner as well as board approval. Lenders typically will require the board of directors to provide evidence of authorization for a loan and may require an attorney's opinion that the major repairs and loan are duly authorized. The fact that board members are volunteers whose terms of office are limited gives a greater argument for homeowner approval of the major repairs and of obtaining a loan to pay their cost.

continued on page 11

continued from page 10

If the board of directors lacks the authority under the governing documents to effect major repairs or to borrow funds, the board should seek to amend the governing documents at the time it seeks homeowner approval for the major repairs and for authorizing the obtaining of a loan to fund their cost. This action will alleviate this obstacle for loans to fund future major repairs. It is at this point the board should work hand-in-glove with the association's legal counsel.

iii. **Lender Due Diligence.** The lender should perform many of the due diligence activities that it would do for any other type of real estate improvement or construction loan. For example, the lender should have its architect, engineer or construction inspector review the schedule, the plans and specifications, and the cost estimates and bids for the major repairs. In addition, the lender should inspect the property to ascertain whether it is being well maintained. Are the lawns and other landscaping attractive? Are the recreation facilities, if any, maintained? Do the buildings need painting?

The lender should then review the books and records of the association to determine whether the association budget is adequate not only to pay off the loan, but also to maintain the common elements of the community. It should determine how many homeowners are delinquent in the payment of their maintenance fees and what measures the association is taking to collect such delinquencies. It should have its counsel review the declaration, bylaws (code of regulations), resolutions, and the articles of incorporation of the association to determine whether such documents comply with state law and which provisions affect the rights and obligations of a lender. The lender should check the historic sales prices of homes in the community to ascertain whether they have declined in value, have held their value, or have appreciated in value. Naturally, a loan to an association whose homes have held or have appreciated in value is more comforting to a lender than a loan to an association whose homes have declined in value. The lender should also examine owner turnover to determine the stability of the community and, if the documents permit owners to lease a home, the number of leased homes. Generally, a community that has little owner turnover or has a large percentage of owner occupied homes is a better credit risk than a community that has a high owner turnover and/or a large percentage of investor-owned rented homes.

iv. **Loan Documentation.** The documentation for a loan to an association is similar in many respects to a real estate improvement or construction loan, but with one major exception: the loan generally is not secured by a mortgage on real estate. This deviation is required because a condominium association generally does not own the common elements, including the real estate (the common elements are owned by the homeowners as tenants-in-common). In other types of communities, the homeowners' association does own the common areas but they have little or no value for loan collateral purposes because the common areas are subject to homeowners' association documents that prime any mortgage. Therefore, instead of using real estate as collateral, the loan is secured by a pledge or collateral assignment by the association of assessments (generally a special assessment approved by the homeowners) to the lender, which is similar to the assigning by a commercial borrower of accounts receivable to a lender as security for a loan. The following is a list of the documents that will generally be used to originate, evidence or secure a loan to an association to finance major repairs.

(a) **Loan Application/Commitment.** The loan application submitted by the association to the lender sets forth the basis for the loan. At the time the association delivers the application to the lender, the lender will generally require a loan application fee. The loan application is typically on a form provided by the lender and contains the borrower's name, the loan amount, the loan purpose, and the loan term. Sometimes the application will "ripen" into a

continued on page 12

continued from page 11

loan commitment upon acceptance by the lender, but more typically the lender will issue a separate loan commitment. From the association's point of view, the more detailed the loan application and loan commitment, the better. A comprehensive loan application and loan commitment will help avoid future misunderstandings about the loan terms and the loan documents. If a loan does not go forward because the lender is not satisfied with the appraisal, the association's financial records, the condition of the property, or other matters not within the association's control, the lender should refund to the association the application and/or commitment fee, less the lender's direct out-of-pocket expenses.

(b) **Loan Agreement.** All the documents that will evidence or secure the loan flow out of the loan agreement between the lender and association. The loan agreement will contain provisions dealing with the following matters:

(1) the fees and expenses to be charged to the association;

(2) conditions for disbursements of loan proceeds, including budget requirements, retainage requirements, permit requirements, and bonding and insurance requirements;

(3) representations and warranties that the loan documents have been duly authorized and that they do not violate the provisions of the governing documents or any other documents to which the association is bound;

(4) the financial statements given by the association to the lender fairly present the financial condition of the association as of the statement dates and that there has been no adverse change in the association's financial condition since such dates;

(5) that while the loan is outstanding, the association will maintain its existence and will not amend its governing documents without the lender's prior written consent;

(6) that the plans and specifications for the work comply with all laws and regulations, including zoning and building laws;

(7) that the association is not aware that the property contains hazardous or toxic substances or pollutants as defined by federal, state or local laws or rules and regulations;

(8) that while the loan is outstanding, the association will covenant not to materially amend or deviate from the approved plans and specifications for the work without the lender's prior approval, will provide funds to cover any cost overruns, will comply with the mechanics' lien laws of the state and will discharge any lien or claim filed for the work, will provide the lender with a list of all homeowners whose assessments are delinquent beyond a specified period of time (60 days, for example) and will file a lien against a delinquent homeowner and initiate collection proceedings if the assessment remains delinquent for a specified period of time (90 days, for example);

(9) that give the lender the right (but not the obligation) to take over and complete construction if the association defaults; and

(10) that, if permitted in the jurisdiction where the property is located, provide for the association to pay the lender's legal fees and for both parties to waive their rights to a jury trial.

(c) **Promissory Note Evidencing the Loan.** Typically, the association will pay interest during the construction period (generally the first year or two of the loan) and will make monthly payments of principal and interest for the balance of the term of the loan (generally a term not to exceed five to seven years from the inception of the loan). During the construction term, interest typically will be paid from the loan proceeds. Generally, the mortgage note will "float" against "prime" or another recognized loan index during the construction period and will be "fixed" during the loan amortization period.

continued on page 13

continued from page 9

(d) **Security Agreement.** The security agreement between the association and the lender will provide for the collateral for the loan to be a special assessment passed by the board of directors and, most likely, also passed by the homeowners. In addition, if the assessment is not uniformly imposed on each homeowner, the association should provide the lender with a schedule showing the percentage interest of each home in the common elements in the community and the amount of the assessment attributable to each home.

(e) **UCC Financing Statements.** UCC financing statements should be prepared and filed, perfecting the lender's security interest in the special assessment and other collateral for the loan.

(f) **Collateral Assignments.** The following collateral assignments are also commonly used:

(1) collateral assignment of permits, licenses, contracts, and warranties;

(2) collateral assignment of architect's and/or engineer's contracts, with acknowledgment of the assignments by the architect and/or engineer;

(3) collateral assignment of the construction contract with the acknowledgment of the assignment by the general contractor;

(4) collateral assignment of condominium assessments, to give the lender the right to enforce the assessments against delinquent homeowners, if the association fails to perform such enforcement, and the right to seek the appointment of a receiver;

(5) collateral assignment of insurance proceeds;

(6) collateral assignment of the management agreement, with the acknowledgment by the management company of such assignment; and

(7) collateral assignment of deposit account and operating accounts to be established by the association with the lender.

(g) **Due Diligence.** Typically, the following due diligence items will be required:

(1) **Insurance.** Hazard and liability insurance coverage with evidence of payment of the first year's premium.

(2) **Legal Opinion.** A legal opinion from the association's legal counsel stating that the association is a not-for-profit corporation duly organized and validly existing in the state where the common ownership community is located, is in good standing, and has the legal capacity and authority to perform its obligations under the loan documents; that the major repairs have been duly authorized by the homeowners and the board of directors; that the signing, delivery and performance of the loan documents have been duly authorized by the homeowners and the board of directors and do not violate the governing documents of the association; that the loan documents are valid and binding obligations of the association, enforceable in accordance with their terms; and that the lender has a first lien and perfected security interest in the special assessments securing the loan.

(3) **Certified Copies of Agreements.** Complete and accurate certified copies of management agreement, service contracts, and other agreements in connection with the use, operation, management, maintenance, or repair of the community.

(4) **Certified Copies of Governing Documents.** Complete and accurate certified copies of the recorded articles of incorporation of the association, condominium declaration or homeowners' declaration, bylaws (code of regulations) of the association, and all amendments to such documents, certified by the secretary of the association as true, complete, and correct, and a good standing certificate issued by the secretary of state of the state in which the community is situated. The lender may require

continued on page 14

continued from page 13

a covenant from the association that it will not allow the declaration and other governing documents of the association to be amended while the loan is outstanding without the prior written consent of the lender.

(5) **Resolutions.** Resolutions of the board of directors and of the homeowners authorizing the major repairs, the assessments, and the loan.

(6) **Financial Information.** Copies of the last three years' financial statements of the association and a schedule of any delinquent homeowners.

B. **Notice to Homebuyers of Assessment and Loan.** The lender should make sure that the association provides notice of the special assessment to the prospective purchasers of homes within the community and obtains the assumption by each purchaser of the assessment on the home being purchased. To the extent practicable, the association should also require homeowners who are selling their homes to include a provision in the sales contract disclosing the assessment and requiring the buyer to assume it. In addition, some states have adopted legislation requiring a "seller's residential disclosure statement" form for the resale of homes that specifically requires a seller to disclose any pending or proposed assessments. Of course, by negotiation between the parties, the sales contract can provide for the selling homeowner to pay off the unpaid balance of the assessment attributable to his or her home, in which event the home will be conveyed free and clear of the assessment. If this occurs, the association should pay these funds to the lender and provide the buyer with an acknowledgment from both the lender and the association that the assessment against the home has been paid.

Conclusion. Although a loan to an association does not "fit" traditional loan parameters, the loan, if properly underwritten, should be looked upon favorably by a lender. Not only will the loan enhance the lender's portfolio, but it also will provide the lender with an excellent marketing tool to attract personal and business loans and accounts from the residents of the community. ■

Leasing Committee Lease Clause Project

by Andy Lubin

Approximately 18 months ago the Leasing Committee initiated an on-line specialty lease clause site for use by College Fellows. The purpose of the project was to create a bank of lease clauses so that similarly situated Fellows did not have to reinvent the wheel. Examples include provisions relating to the disposal of medical waste, noise prohibitions, mold, odor containment, use of satellite dishes and child care facilities.

While we have approximately 35 clauses, the viability of the project depends on your continuing contributions. All we are asking is for you to provide the clause and identify whether it is has a landlord, tenant or neutral orientation. If you would like attribution, we can include it on the web site, but it is not required. We do not expect you to edit it nor will we be editing it. It is simply to provide a useful starting point and source of information for the College.

We know you all have something to contribute. Clauses can be sent to either Andy Lubin alubin@npmlaw.com or Rod Clement at rclement@brunini.com. Existing lease clauses can be found at the Committee's Web page under "Projects". Thank you for your help. ■

ACREL Leasing Committee Report

by Rod Clement, Chair

The Leasing Committee's main focus has been on green leasing, insurance, retail leasing problems and our lease clause project.

The Leasing Committee is collecting specialized leasing clauses and posting them on its website. The purpose is to provide Fellows with a starting point when they have to draft leases with unusual features. For example, we currently have leases clauses covering child care facilities, hospitals, restaurants, emergency generators, sidewalk elevators and video screens. *(Andy Lubin has an article on this project in this edition of the Newsletter that provides more details on this project.)*

We have had guest speakers on green leasing at the Leasing Committee meetings in San Francisco and Washington. We helped organize the main program and workshop on green leasing presented by Leasing Committee members Vicki Harding and Terry Shea at the meeting in Washington DC. Jake Reby spoke on green restaurants at the Puerto Rico meeting, and turned this presentation into an article for the Practical Real Estate Lawyer. This topic continues to gain momentum. We are looking for volunteers to help with preparing a list of issues that are especially important in green leases, with landlord and tenant alternatives.

Insurance in leases is a continuing subject of concern and discussion among Leasing Committee members. We have had joint telephone conferences with the Insurance Committee on this topic and had a joint breakout session on this topic at the Washington DC meeting at which Art Pape, Bill Locke, Marilyn Maloney and Vicki Harding spoke. Members of the Insurance Committee and the Leasing Committee participated in the ACORD working group on the Evidence of Commercial Property Insurance Form and have kept their members up to date on this topic. The Leasing Committee and the Insurance Committee also have worked on a proposed insurance clause for a lease. This clause is a work in progress; the current draft is posted on the Leasing Committee's website. We also have worked with the Insurance Committee on a draft of a proposed letter from a tenant's lawyer to the tenant's insurance agent regarding the landlord's insurance requirements. A current draft of this letter is posted on the Leasing Committee website. We would like to find an insurance professional who is knowledgeable about current practices in the industry to speak to the Leasing and Insurance Committees on a telephone call and would appreciate any assistance that any of the Fellows could provide in this regard.

The carnage in the retail leasing sector has been a source of much discussion among the Leasing Committee. Leasing Committee members Mark Hennigh, Rick Mallory, Ed Menzie and Howard Steindler put on a main program and workshop on this topic at the Puerto Rico meeting. David Rabinowitz is going to lead a telephone conference on this topic; the call currently is scheduled for December 16. We are also trying to keep our members informed on new cases in this area. New Leasing Committee members Russell Bershad and Mindy Stern spoke on new cases in this area at the Washington meeting. A summary of recent commercial retail leasing cases is posted on the Committee's website. We have also posted current articles about this issue on the Leasing Committee website. We are always looking for volunteers to summarize new cases for the benefit of the Committee.

Finally, we are working on the problem of mold and how to address this in leases. This subject is an extension of an earlier project regarding environmental provisions in leases. The environmental clause and earlier research regarding mold are posted on the Leasing Committee website. Terry Shea is taking the lead on this project.

The Leasing Committee is always looking for ideas for projects that would benefit the College. Contact Rod Clement at rclement@brunini.com or Andy Lubin at alubin@npmlaw.com with any ideas. ■

Pennies from Heaven: Solar Power in the Retail Sector

by Valerie T. Blair and Mark S. Hennigh, Greene Radovsky Maloney Share & Hennigh LLP, San Francisco, CA

Introduction: Solar Energy and Savings

As many retailers and shopping center owners have already discovered, there has never been a better time to "go green." In addition to serving as an enormous marketing asset and a smart geopolitical choice, an investment in solar equipment can translate into lucrative tax savings for a retail business or shopping center owner. The following summarizes selected state and federal incentives that promote investments in solar energy in the retail sector.

In addition to the tax savings and cash incentives provided by government entities, a retailer or shopping center owner can save money on utility bills by using self-generated solar energy instead of utility-provided electricity.

The two most common forms of solar energy are photovoltaic ("PV") systems and solar thermal systems. Most conventional solar panels are composed of PV cells, which convert sunlight into direct current ("DC") electricity. An "inverter" inverts the DC energy into the alternating current ("AC") energy that powers buildings and appliances.[1] Solar thermal systems use heat from the sun to produce energy or hot water. Because PV systems are most relevant to the bulk of commercial solar customers, references to "solar panels" or "solar equipment" in this memorandum indicate PV systems unless otherwise specified.

In some states, buildings with photovoltaic solar installations are interconnected with the regional, utility-run electricity grid. Through a process known as "net metering," solar equipment producing electricity in excess of what a building consumes transmits the surplus solar-generated electricity directly into the utility grid, and the building's bi-directional energy meter (which measures the building's net electricity usage and production) runs backward. Customers are credited for the full retail value of the solar-generated energy that they transmit to the grid, which can reduce (or, hypothetically, even eliminate) their utility bills, depending on the net energy measurement.[2]

Federal Incentives

The Federal Tax Code (the "Tax Code") contains numerous incentives designed to encourage investment in renewable energy. The following section will identify important solar energy incentives that are currently available to retail businesses and shopping center owners.[3]

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1 *See* Go Solar California, *Consumer Guide to the California Solar Initiative* 4-5 (2008) *available at* http://www.energy.ca.gov/2008publications/CPUC-1000-2008-026/CPUC-1000-2008-026.PDF (last visited July 30, 2009) for basic explanations of solar energy processes.

2 *Id.* at 5. Net metering will be discussed in section III.

3 Many of the energy incentives discussed in this memorandum are applicable to multiple types of renewable energy in addition to solar, such as biomass, geothermal, or wind. For the sake of brevity and relevance, only solar is discussed here, but the reader can look at the cited statutes and regulations for information on other technologies. In addition, the reader may notice that certain prominent energy incentives are not addressed in this memorandum. These are omitted either because they do not apply directly to commercial taxpayers or because they do not currently apply to solar energy. For example, Clean Renewable Energy Bonds, also known as "CREBS," are federal loans primarily available only for the public sector, *see* 26 U.S.C. § 54, and Production Tax Credits or "PTCs" for solar energy have been replaced by other, more lucrative solar incentives, *see* 26 U.S.C. §§ 45, 48(a)(3).

continued on page 17

continued from page 16

A. Commercial Taxpayer Election: 30% Tax Credit or 30% Treasury Grant for Commercial Investments in Solar Equipment

The American Recovery and Reinvestment Act of 2009 ("ARRA") provides the commercial retailer with unprecedented incentives, and makes investment in solar energy equipment more cost effective and feasible than ever before.[4] As explained below, a commercial taxpayer who invests in solar equipment before December 31, 2016 may choose between a 30% Business Energy Investment Tax Credit ("ITC"), or a 30% U.S. Treasury Renewable Energy Grant, to partially finance a solar investment.

1. The 30% Business Energy Investment Tax Credit ("ITC")

Section 48 of the Tax Code provides a 30% ITC to commercial and industrial taxpayers who invest in solar energy property.[5] The ITC was expanded significantly by the Energy Improvement and Extension Act of 2008, and again by the ARRA.[6] ITCs now apply to solar equipment placed in service on or before December 31, 2016. The credit is equal to 30% of expenditures on the solar equipment and installation, with no maximum limit.

(a) Definition of Solar Energy Property Eligible for the ITC

Solar energy property eligible for the 30% ITC includes equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Hybrid solar lighting systems, which use solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight, are also eligible.[7]

To qualify for the ITC, the taxpayer must either (1) complete the construction, reconstruction, or erection of the energy property or (2) acquire and become the original user of the energy property.[8] The property must also be depreciable or amortizable, and must meet the Department of Energy's performance and quality standards in effect at the time the property is acquired.[9]

(b) ITC No Longer Reduced by Receipt of "Subsidized Energy Financing"

Prior to the enactment of the ARRA in 2009, a taxpayer's eligibility for the ITC was reduced if that taxpayer received "subsidized energy financing," (defined as "financing provided under a Federal, State, or local program a principle purpose of which is to provide subsidized financing for projects designed to conserve or produce energy").[10] The ARRA repealed the "subsidized energy financing" limitation for all projects placed into service after December 31, 2008.[11] It is important to note that, now, commercial taxpayers can take advantage of the 30%

4 Many of the energy incentives discussed in this memorandum are applicable to multiple types of renewable energy in addition to solar, such as biomass, geothermal, or wind. For the sake of brevity and relevance, only solar is discussed here, but the reader can look at the cited statutes and regulations for information on other technologies. In addition, the reader may notice that certain prominent energy incentives are not addressed in this memorandum. These are omitted either because they do not apply directly to commercial taxpayers or because they do not currently apply to solar energy. For example, Clean Renewable Energy Bonds, also known as "CREBS," are federal loans primarily available only for the public sector, *see* 26 U.S.C. § 54, and Production Tax Credits or "PTCs" for solar energy have been replaced by other, more lucrative solar incentives, *see* 26 U.S.C. §§ 45, 48(a)(3).

5 *See* 26 U.S.C. § 48.

6 *See* ARRA § 1603.

7 26 U.S.C. § 48(a)(3)(A)(i)-(ii). The main exclusions from ITC eligibility, passive solar systems and solar pool-heating systems, are generally not relevant to the commercial retail sector. *See* 26 U.S.C. § 48(a)(3)(A)(i).

8 26 U.S.C. § 48(a)(3)(B).

9 26 U.S.C. § 48(a)(3)(C), (D).

10 *See* 26 U.S.C. § 48(a)(4)(A)-(C).

11 *See* 26 U.S.C. § 48(a)(4)(D) (as amended in 2009).

continued on page 18

continued from page 17

ITC *in addition to* other valuable energy finance subsidies as specified by the Internal Revenue Service. Moreover, unused commercial credits can be carried forward for up to 20 years.[12]

(c) New Option: U.S. Treasury Renewable Energy Grant in Lieu of ITC

In order to encourage investment in specified types of energy during the Great Recession, the ARRA introduced U.S. Treasury Renewable Energy Grants, giving commercial taxpayers the option to receive a prompt cash grant to fund their solar investments, rather than waiting to claim the credit.[13] The Treasury Grant alternative is an extremely valuable resource for commercial taxpayers, and is discussed in more detail in the next section. It is worth repeating, however, that the grant is an *alternative* to the ITC[14]—indeed, an alternative that many businesses, including the retail industry, will find is even more valuable than the 30% ITC.

2. U.S. Department of Treasury Renewable Energy Cash Grants

Section 1603 of the ARRA provides for U.S. Treasury cash grants to reimburse eligible taxpayers for a portion of the expense of placing in service specified energy property.[15] Congress's purpose in adopting the ARRA was to promote economic recovery and job growth to counteract the recession, and to invest in technology, environmental protection, and infrastructure that would provide long-term economic benefits.[16]

As many business people know all too well, the recession has taken a toll on company balance sheets. Companies with smaller taxable incomes owe less in federal taxes, and this has reduced the appeal and the effectiveness of corporate tax deduction incentives like the ITC. The Treasury grants were designed to "temporarily fill the gap created by the diminished investor demand for tax credits" by essentially replacing the ITC credit scheme with a rapid 30% cash reimbursement for solar investments that meet certain requirements.[17]

(a) Terms of Grant

The ARRA Renewable Energy Grants are available to commercial taxpayers under conditions very similar to those for ITCs, as described in Tax Code section 48. The main differences between the ITCs and the Grants are: (1) the timeframe within the energy property must be placed in service, and (2) the fact that a taxpayer must apply for a Grant.[18]

To qualify for the Grant, the energy property must be: (1) placed in service—i.e., ready and available for use—between January 1, 2009 and December 31, 2010 (or, under the safe harbor for solar energy, the property qualifies if it is under construction by December 31, 2010 and also placed in service by December 31, 2016);[19] (2) constructed by the taxpayer or under contract for the taxpayer, with the taxpayer as the original user; it must also be (3) tangible personal property (not the building itself) that falls under the definition of "specified energy property" provided in Tax Code section 48; and (4) the property and

12 Solar Energy Industries Association, *Federal Solar Energy Incentives: Frequently-Asked Questions* (May 21, 2009) available at www.seia.org (last visited July 28, 2009).

13 *See* ARRA: H.R. 1, Div. B, §§ 1104, 1603 (2009).

14 *See* 26 U.S.C. § 48(d).

15 ARRA § 1603(a).

16 ARRA § 3.

17 *See* U.S. Treasury Dept. Grant Program Guidance pg. 3-5 (July 2009) *available at* www.treas.gov/recovery/docs/guidance.pdf (last visited July 29, 2009).

18 *Compare* ARRA § 1603(a) *with* 26 U.S.C. § 48(a).

19 U.S. Treasury Dept. Grant Program Guidance at 5. Construction commences for the purpose of the credit termination "safe harbor" when the taxpayer incurs or pays more than 5% of the total cost of the energy property. *Id*. at 6-7.

continued on page 19

continued from page 18

taxpayer must meet a series of other documentation and definitional requirements.[20]

With respect to solar property, the Grants track the definitions provided in Tax Code section 48(a), the section that establishes the framework for ITCs.[21] Commercial, industrial, and agricultural tax-paying entities are eligible for the Grants.[22]

The "eligible basis" of the energy property is the dollar amount to which the 30% measure is applied to determine the Grant—it includes the property's full cost, without depreciation, including costs incurred in installation, freight, and construction.[23] Notably, a taxpayer need not own the energy property in order to claim the ARRA Treasury Grant. A lessor who is otherwise eligible to receive a payment under ARRA section 1603 may pass the Grant on to a lessee, as long as the lessee is also eligible under section 1603 and the transaction meets certain reporting and consent requirements.[24]

The Treasury Department will make the Grant payment within 60 days of the Grant application date or the date the property is placed in service, whichever is later.[25]

If the property is acquired by a disqualified person, or otherwise ceases to be a specified energy property within five years of being placed in service, the Grant must be repaid to the Treasury (in full or in part, depending upon the timing of the disqualifying event).[26]

(b) Making the Election between a Grant and an ITC

Any property receiving a Treasury Grant under ARRA section 1603 is disqualified from the ITC, and vice versa. If both are allowed, recapture applies.[27]

Congress gave solar energy property the most favorable treatment possible under the ARRA Treasury Grant scheme. Whereas several other categories of renewable energy are bound by a more limiting termination date (before 2014) or a lower percentage-of-basis grant amount (10%), solar energy property enjoys the generous combination of a January 1, 2017 credit termination date and is entitled to be reimbursed with a Grant equal to 30% of basis cost.[28]

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20 *Id.*

21 Please refer to the discussion and definitions in section II(1)(a) of this memorandum, *supra*.

22 The Database of State Incentives for Renewables & Efficiency ("DSIRE") provides a good summary of additional specifications:

Federal, state and local government bodies, non-profits, qualified energy tax credit bond lenders, and cooperative electric companies are not eligible to receive this grant. Partnerships or pass-thru entities for the organizations described above are also not eligible to receive this grant, except in cases where the ineligible party only owns an indirect interest in the applicant through a taxable C corporation.

DSIRE, Summary of U.S. Department of Treasury – Renewable Energy Grants (updated Jul. 9, 2009), *available at* www.dsireusa.org/incentives (visited July 28, 2009).

23 U.S. Treasury Dept. Grant Program Guidance at 15-16.

24 *Id.* at 17. A sale-and-leaseback transaction may also qualify if it meets the Treasury's stated requirements, provided *id.* at 17-18.

25 *Id.* at 2.

26 *Id.* at 18.

27 26 U.S.C. § 48(d). "Recapture" has been defined as "a sort of revenge the Code imposes on taxpayers for what turns out to be, with the benefit of hindsight, claims to undue tax benefits. Recapture imposes current tax burdens, rather than adjustments to prior years, usually in the form of either (1) increased ordinary income to offset claims for undue previous deductions; or (2) direct tax liabilities as a result of what, in retrospect, were excessive claims for previous tax credits." Richard A. Westin, WG&L Tax Dictionary 651 (RIA 2004).

28 See footnote next page

continued on page 20

continued from page 19

In June 2009, the U.S. Department of Treasury issued guidance on how to elect the Grant instead of the ITC.[29]

Because the economic climate is presently unkind to many balance sheets, and because the benefits of the ARRA Treasury Grants are much the same as the benefits of ITC, only better and more immediate, a commercial taxpayer investing in solar energy would be wise to apply for the ARRA Grant, if it is possible to satisfy the requirements.

B. Other Notable Federal Tax Incentives for Solar Investment

1. Energy-Efficient Commercial Buildings Tax Deduction

Tax Code section 179D(a) provides a tax deduction for energy efficient commercial buildings.[30] The deduction, established by the

28 U.S. Treasury Dept. Grant Program Guidance at 5. The "termination date" is simply the date the property must be placed in service. *Id.* at 2. The table in the Treasury's guidance document provides a nice illustration of the advantage of solar energy property:

Specified Energy Property	Credit Termination Date	Applicable Percentage of Eligible Cost Basis
Large Wind	Jan 1, 2013	30%
Closed-Loop Biomass Facility	Jan 1, 2014	30%
Open-loop Biomass Facility	Jan 1, 2014	30%
Geothermal under IRC sec. 45	Jan 1, 2014	30%
Landfill Gas Facility	Jan 1, 2014	30%
Trash Facility	Jan 1, 2014	30%
Qualified Hydropower Facility	Jan 1, 2014	30%
Marine & Hydrokinetic	Jan 1, 2014	30%
Solar	Jan 1, 2017	30%
Geothermal under IRC sec. 48	Jan 1, 2017	10%*
Fuel Cells	Jan 1, 2017	30%**
Microturbines	Jan 1, 2017	10%***
Combined Heat & Power	Jan 1, 2017	10%
Small Wind	Jan 1, 2017	30%
Geothermal Heat Pumps	Jan 1, 2017	10%

*Geothermal Property that meets the definitions of qualified property in both § 45 and § 48 is allowed either the 30% credit or the 10% credit but not both.

** For fuel cell property the maximum amount of the payment may not exceed an amount equal to $1,500 for each 0.5 kilowatt of capacity.

*** For microturbine property the maximum amount of the payment may not exceed an amount equal to $200 for each kilowatt of capacity.

Id. (highlighting added).

29 *See id.*

30 26 U.S.C. § 179D.

continued on page 21

continued from page 20

Energy Policy Act of 2005, applies to qualifying energy-efficient commercial buildings and systems placed in service between January 1, 2006 and December 31, 2013.[31] This tax deduction can provide commercial building owners and tenants with tax savings of between $0.30 and $1.80 per square foot, depending on the nature of the installations and the identity of the taxpayer (i.e., owner versus tenant; commercial versus government sector).

"Energy efficient commercial building property" is defined in Tax Code section 179D(c)(1).[32] The tax deduction is taken in the year that construction is completed.[33]

2. The Modified Accelerated Cost-Recovery System (MACRS)

Under the Modified Accelerated Cost-Recovery System ("MACRS"), codified in Tax Code section 168, certain investments in solar power and other types of projects can be recovered through accelerated income tax deductions for depreciation. The federal Economic Stimulus Act of 2008 included a 50% bonus depreciation provision for eligible renewable-energy systems acquired and placed in service in 2008; and the bonus depreciation provision was extended through the 2009 tax year by the ARRA.[34] Moreover, a MACRS-eligible commercial photovoltaic solar project taking the ITC will usually be able to further reduce the depreciable basis, providing a cumulative depreciation of as much as 85% of the project's installed cost, using a 5-year MACRS schedule.[35]

3. U.S. Department of Energy Loan Guarantee Program

The Department of Energy ("DOE") is authorized to issue loan guarantees for new or significantly improved technologies in energy projects.[36] The ARRA extended the DOE's loan guarantee program through September 30, 2011; and appropriated $6 billion for the program.[37]

Conclusion

Federal and state programs are offering unprecedented incentives to "go solar," but businesses must act quickly to take full advantage of them. The federal government's unparalleled 30% grant is available only for a limited time, and the 30% ITC is scheduled to revert back to 10% in 2017. Moreover, the cash incentives under the CSI program are gradually decreasing. At both the state and federal level, economic incentives for commercial investment in solar energy are at an all-time high. A company would be wise to consider "going solar" now, because the going may never be this good again. ■

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31 *See id.* (as amended by the Energy Improvement and Extension Act of 2008, H.R. 1424: Div. B § 303).

32 As provided in 26 U.S.C. § 179D(c)(1), "energy efficient building property" is property: (1) for which depreciation is allowable, (2) which is installed on or in a building in the U.S., within the scope of Standard 90.1-2001 of the American Society of heating, Refrigerating and Air Conditioning Engineers and the Illuminating Engineering Society of North America, (3) which is installed as part of the interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope, and (4) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs for the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50% or more in comparison to a "reference building" that meets the minimum requirements of Standard 90.1-2001, using methods of calculation specified by the Internal Revenue Service. For more information and answers to frequently asked questions, see the website of the Commercial Building Tax Deduction Coalition, *available at* http://www.efficientbuildings.org (last visited July 29, 2009).

33 *See* 26 U.S.C. § 179D.

34 *See* 26 U.S.C. § 168(k); *see also* DSIRE, Modified Accelerated Cost-Recovery System (MACRS) + Bonus Depreciation (2008-2009) (last reviewed Feb. 19, 2009) *available at* http://www.dsireusa.org/incentives (visited Jul. 29, 2009).

35 Mark Bolinger, *Financing Non-Residential Photovoltaic Projects: Options and Implications* at 6 (Lawrence Berkeley Nat'l Lab., Jan. 2009), *available at* http://eetd.lbl.gov/ea/emp (last visited July 24, 2009).

36 *See* 42 U.S.C. § 16511 et seq., as amended by the Energy Policy Act of 2005 and extended by the ARRA of 2009.

37 *See id.*; *see also* ARRA, Pub. L. No. 111-5, 123 Stat. 115, *supra*.

The Uniform Partition of Inherited Property Act: A Report from the ACREL Observer to the Drafting Committee

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Background At the end of the Civil War, freed slaves began acquiring tracts of land in the former Confederate states. In some cases they received the proverbial "forty acres and a mule" as part of a land reallocation process as the Civil War was winding down, while in other cases they simply purchased the land. The amount of southern land owned by African-Americans peaked at more than fifteen million acres in 1910; in that year, approximately one-sixth of all southern landowners were black. Today, African-Americans own or co-own at most three million acres of America's agricultural property, with some estimates running as low as two million acres.

Much of the land that was acquired by African-American families passed from generation to generation by intestacy. In many cases this land was relatively inaccessible and was viewed as undesirable, which meant that there was little commercial market for the land. In addition, a combination of limited access to lawyers, a lack of familiarity with the legal system, and a distrust of that system meant that family interests in this property tended to fractionate over time as partial owners continued to die intestate. Generations passed, and much of this property came to be owned by numerous cousins in tenancy in common. As the nation urbanized during the mid-1900s, many of these cousins moved north, with the remaining occupants of the land sometimes losing sight of the fact that their distant—and often unknown—relatives were co-owners of this property.

As property values began to increase in recent decades, and as land that formerly was seen as remote fields and swamps came to be viewed as sites for tomorrow's condominiums and golf courses, commercial interest in this property grew dramatically. Developers who sought to acquire this property sometimes found it difficult or impossible to negotiate to purchase the land, given that a lot might be owned by hundreds of cousins, some of whom could not be identified or located. Moreover, resort to the partition process might enable them to acquire the property at a lower price than they could negotiate in an arm's-length sale. In numerous documented cases, parties who wished to acquire this land would purchase a single cotenant's interest, thereby affording them the legal right to seek partition of the entire parcel. If the court ordered partition by sale, this outsider might be the only party with the financial capacity to acquire the property, often at a price far below its fair market value as a unitary lot. The partition process is one of the primary causes of African-American land loss in the past several decades.

The Need for a Uniform Act Several years ago, the National Bar Association and the American Bar Association's Real Property, Trust and Estate Law Section jointly formed the Property Preservation Task Force, of which I was a member. After considering a wide range of methods to address the problem of African-American land loss, the Task Force submitted a proposal to the Joint Editorial Board of the National Conference of Commissioners on Uniform State Laws (NCCUSL) recommending that it consider drafting a Uniform Act to govern this narrow category of partition actions. The Uniform Law Commission (ULC) formed a Drafting Committee, and I have served as ACREL's Observer to this Drafting Committee since January 2008.

continued on page 23

The Uniform Partition...

continued from page 22

The Drafting Committee met three times before submitting a draft Act to the Uniform Law Commission for a first reading at its Annual Meeting in July 2009. Shortly afterwards, the Committee received a transcript of the Annual Meeting discussion, along with written comments from other Commissioners, and the Committee then met again in November 2009 to revise the draft to incorporate many of these comments. The Drafting Committee will meet again in March 2010 and then will submit a final draft Act to ULC for a second and final reading at its Annual Meeting in July 2010. If ULC approves the Act at that meeting, it will become a Uniform Act that states may begin to adopt.

The remainder of this article will summarize the ongoing drafting process, focusing on the most recent written draft, dated July 2009 and available at http://www.law.upenn.edu/bll/archives/ulc/utcpa/2009_amdraft.pdf, and the modifications to that version of the Act that the Drafting Committee agreed to make at its November 2009 meeting. The next revised version of the Act, incorporating these most recent discussions, will be available in March 2010.

The Narrow Scope of the Proposed Act As a starting point, it is important to note the very narrow scope of this Act. The Act assumes that most of the law of tenancy in common, including the partition process, is well established in every state and does not need modification. Rather, the goal of the Act is simply to modify the partition process in cases involving "heirs' property." Thus, one of the most important issues the Committee considered is the definition of heirs' property. The current draft limits the applicability of the Act to property that meets the following three criteria:

(1) no written agreement among all the cotenants governs the ownership of the property; and

(2) one or more of the cotenants acquired title from an ancestor who owned an interest in the property; and

(3) any of the following is true:

(a) 20% or more of the cotenants are related by blood, marriage, or adoption;

(b) 20% or more of the interests are held by one or more individuals who acquired title from an ancestor; or

(c) 20% or more of the interests are held by cotenants who are related by blood, marriage, or adoption.

This definition is designed to encompass much of the land that has been held by the same family for more than one generation while excluding commercial tenancies in common, which are nearly always governed by a written agreement among the parties. To the ACREL Fellow whose practice involves commercial tenancy-in-common agreements, this Act is likely to be inapplicable, and the agreement among the parties and existing state law will continue to govern any possible partition actions that might arise in the future. While no definition is perfect, and any definition is likely to be both over- and under-inclusive in particular cases, the Committee concluded that this definition is likely to address the problem in most cases in which it arises without creating very many new problems.

Notice to the Respondents Partition actions concerning heirs' property often involve respondents who are difficult to locate. In fact, the petitioner and the known respondents may not even be able to identify all of the other respondents. For this reason, the appropriate method of providing notice of the partition action to all of the cotenants is critically important. After extended discussion and much input from Commissioners who attended the Annual Meeting, the Committee

continued on page 24

continued from page 23

agreed that this Act is designed to address the substantive law of partition and not to change well-established state procedure. Thus, the Act will not address issues of notice and assumes that the state's underlying procedural rules will continue to apply to actions to partition heirs' property. The Committee did, however, add one modest procedural requirement: Petitioners must post notice of the pending partition action at the property.

Invocation of the Act The Committee spent a considerable amount of time discussing the question of who must invoke the Act, ultimately concluding that the judge shall be required to invoke this Act in those cases in which it applies. Some Commissioners had suggested at the Annual Meeting that the Act should apply only if one of the parties invoked it. However, the Committee recognized that petitioners in these types of actions generally do not want the Act to apply, while respondents—who tend to be precisely the poor, legally unsophisticated, and unrepresented parties this Act is designed to protect—often will be unaware of this Act and the protections it offers to them. Thus, the only practical way for the Act to have any beneficial effect is if the judge is required to invoke it. Presumably, parties who seek to partition heirs' property will quickly come to recognize that future buyers will be thinking about the ultimate marketability and insurability of the title, and will be aware that title companies will review partition judgments to make sure that the judge did invoke the Act in cases in which it applies.

Method of Partition A fourth critical issue is the method of partition that courts should apply. In many states, partition in kind is supposed to be the preferred method of partition wherever feasible. Yet despite the fact that agricultural property can often be partitioned in kind fairly readily, courts in many states have shown a marked preference in the actual cases for holding partition sales if the petitioner requests. The Act would reaffirm the underlying law, by establishing a hierarchy of remedies. Most importantly, partition in kind is to be the preferred remedy, and a court may order partition by sale only if the petitioner establishes by a preponderance of the evidence that partition in kind cannot be made without "great prejudice" to the owners. Note that the Act also authorizes a mixed remedy, under which part of the property is sold and the rest is partitioned in kind.

Section 2-202(b) of the Act lists eight factors for a court to consider in assessing whether there is great prejudice. In addition to traditional economic factors, which focus on the practicality and economic effect of partition in kind, this section also requires the court to examine more personal elements of the cotenants' relationship to the land, such as "evidence of longstanding ownership of the property by any cotenant," "any cotenant's particular sentimental links with or attachment to the property, including any attachments arising out of the fact that the property has ancestral or other unique or special value to one or more of the cotenants," and harm to any cotenant that cannot continue to maintain the current use of the property. It is important to emphasize that these non-economic factors will not affect the allocation of the parties' interests and that no tenant will receive a disproportionate share of the land or the sale proceeds. These non-economic factors are to be considered by the court only when it is deciding which method of partition is warranted. If a court applies these factors, it is likely that more partition actions will result in partition in kind than is currently the case.

Other Issues The four major issues I have already noted—the scope of the Act, the manner of notice to unknown and unlocatable respondents, the question of who must invoke the Act, and the preferred method of partition—go to the core of the problem that the Act is designed to address. The Act is meant to speak to a particular, narrow problem; it can do so effectively only if all parties receive notice of the partition action; the Act will have little effect if it must be invoked by respondents who frequently will be unrepresented and unaware of the Act's protections; and it must restore the law's supposed preference for partition in kind. These four issues dominated the Committee's discussions and the ULC Commissioners are likely to concentrate their discussion on these issues when the Act comes up for its final reading.

The Committee did discuss numerous other ancillary issues. In cases in which all or a part of the property will be sold, the Committee agreed that the court ordinarily will be required to receive an unbiased valuation of the property, with the value determined assuming unitary ownership of the land for its highest and best use. This provision is necessary to ensure that a petitioner who is being bought out receives a fair price for his or her interest. The Committee also retained a provision that typically will require the court to appoint unbiased commissioners to serve in partition actions.

The Act will include a "one-way buyout" provision, under which, in certain cases, the respondents will be permitted to purchase the petitioner's interest but the petitioner will not be permitted to purchase the respondents' interests. Finally, the Committee agreed that partition actions will continue to be governed by the American rule, under which each party pays its own attorneys' fees. However, this provision will be bracketed in the final Act, which will allow individual states to consider whether they wish to depart from this rule.

It has been a pleasure to serve as ACREL's Observer to this Drafting Committee, and it is gratifying to see so many people working so hard for so long to solve a problem that has plagued people who lack legal representation. Of course, the problem of forced partition sales is not restricted to African-American landowners and does not arise only in the Southeastern United States, which means that this Act, if adopted, will solve a problem that arises nationwide and can affect anyone. In fact, two of the other Observers who have served on this project, one of whom is white and the other of whom is black, are members of families that own heirs' property. And while one of these parcels is in coastal South Carolina, the other is in Montana. So the Committee has been able to observe firsthand that, even within a group of knowledgeable lawyers, the issue cuts across racial and geographic lines.

I would like to emphasize the involvement of numerous other ACREL Fellows in this project. The original Property Preservation Task Force was formed when ACREL Fellow Kevin Shepherd headed the ABA RPTE Section, and it is Kevin who invited me to serve both on that Task Force and as ACREL's Observer to the Drafting Committee. ACREL Fellows (and ULC Commissioners) Carl Lisman and Bill Breetz both serve as members of the Drafting Committee, and each has undertaken a significant amount of the drafting and revision. ACREL Fellow Steven Eagle is the ABA Section Advisor to the Drafting Committee. Numerous other ACREL Fellows have served on the Property Preservation Task Force, on the Joint Editorial Board, and as Commissioners to ULC, and they have offered constructive comments on this project. ACREL Fellows have been involved in this worthwhile undertaking from the outset, and the Act has benefited from their many contributions.

For those who are interested in further reading about heirs' property, these issues have been addressed in both the popular press and the academic literature. A group of Associated Press reporters published a three-part series on heirs' property in 2001. Part One is available at http://hartford-hwp.com/archives/45a/390.html and Parts Two and Three are available at http://www.theauthenticvoice.org/Torn_From_The_Land_Intro.html. Professor Thomas W. Mitchell, who serves as

Reporter for the Drafting Committee, authored the leading academic article on the issue, *From Reconstruction to Deconstruction: Undermining Black Landownership, Political Independence, and Community Through Partition Sales of Tenancies in Common*, 95 Nw. U.L. Rev. 505 (2001). And Professors Phyliss Craig-Taylor and Faith Rivers, each of whom serves as a Committee Observer, have published excellent articles on this issue as well. *See* Phyliss Craig-Taylor, *Through a Colored Looking Glass: A View of Judicial Partition, Family Land Loss, and Rule Setting*, 78 Wash. U.L.Q. 737 (2000); Faith Rivers, *Inequity in Equity: The Tragedy of Tenancy in Common for Heirs' Property Owners Facing Partition in Equity*, 17 Temple Pol. & Civ. Rts. L. Rev. 1 (2007). ■