ACREL News

President's Message

As I am writing this message, we are preparing for our Spring Mid-Year Meeting at the Wyndham Rio Mar in Rio Grande, Puerto Rico. At the present, it looks as though we're going to have a good turnout, especially given the current economic conditions. Our future newsletter will have a more detailed report on the meeting and its programs.

With respect to College initiatives, Linda Striefsky and the Changes in Law Firms Task Force have been meeting to consider the impact on the College of changes in the way that law is being practiced. Joining Linda on the Task Force are Vickie Berghel, Jack Fersko, Rob Freedman, Dick Goldberg, Brian Jackson, Bob Nix, Rick Spencer, and Debra Stark. We'll have updates on their activities in future newsletters. Larry Schulman and Fred Joseph have also "volunteered" to examine how our more senior members might be of service to state and local governments by providing experienced counseling or similar services. If you have thoughts about that subject, please call Larry or Fred. Finally, following up on our successful programs last year, Earl Segal and I are beginning to plan for a webinar following the Puerto Rico meeting. If you have ideas about subject matters you'd like to see covered in this program from the College, let either of us know.

As part of the on-going involvement of the College in the Synergy Group, a number of ACREL members teamed with members of the American College of Mortgage Attorneys and the ABA Real Property Trust and Estate Section to put on a webcast program, "Dilemmas Dealing With Deposits, Disbursements, Escrows, And Exchange Funds: Issues To Consider In Depositing Funds With And Disbursing Funds Through Title Insurance, Escrow, And Exchange Service Providers". Cheryl Kelly was the moderator for the program and was joined by Fellows Robert Bozarth, Paul L. Hammann, John Hosack and Kenton L. Kuehnle on the eight-person faculty for the program. Also, Kevin Shepherd and Mark Mehlman are the ACREL representatives to a working group that is preparing a guide to good practices for U.S. transactional lawyers to detect and combat money laundering and

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terrorist financing, building from the Financial Action Task Force RBA Guidance For Legal Professionals. This is an important initiative as the FATF Guidance is going to impact all of our practices in the very near future.

On February 10, 2009, Mark Mehlman participated on a panel that also included David Kuney and Nancy Little in making a presentation to the Mortgage Bankers Association on the topic: “What Do Today’s Borrowers Want?” (as an aside, I’m sure the speakers said more than “money”!).

These stagnant economic times present new and substantial challenges to each of us. During these times, the friendship of the Fellows of the College and the ability to call upon the resources they represent is of more importance than ever. If you have ideas for services that the College can provide, please let me or any of the Board Members know.

Best regards.

Phil

Philip D. Weller, President

STAFF BOX

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Hiding in Plain Sight: PCBs in the 21st Century

by Harry G. Meyer, Hodgson Russ LLP © 2009

If you had asked me about a year ago whether it would be relatively easy to find significant amounts of PCBs (polychlorinated biphenyls) in many older buildings and properties, my answer would have been "I don't think so." Of course, in the back of my mind there would have been the possibility of a long-abandoned manufacturing facility that had not been carefully scrutinized for either spills or old electrical transformers for electrical service with PCBs as the dielectric fluid - but likely nothing more

Although PCBs, valued for chemical stability and fire resistance, were manufactured and processed in our country for almost 50 years from 1929 to 1977, in May 1979 the U. S. Environmental Protection Agency published final regulations banning the manufacture of PCBs and phasing out most PCB uses (44 FR 31514). The EPA rules gradually ended many industrial uses of PCBs over the next five years but did permit their continued use in existing endorsed electrical equipment under carefully controlled conditions. These final regulations followed the initial ban from EPA issued in 1977. (For a thorough listing of EPA rules and other information see http://epa.gov/pcb/pubs/laws.htm.)

Of course, I was aware of a fire in a basement mechanical room of an 18-story office building owned by New York State in Binghamton in 1981. The fire, which lasted for about 30 minutes, cracked a transformer providing service to the building and caused some 180 gallons of insulating PCBs to spill. Ventilation intake ducts spread the oily smoke and soot throughout the building. According to an article in the New York Times on October 11, 1994, this 30-minute fire cost New York State taxpayers about $53,000,000 before the building, which originally cost $17,000,000, was declared safe from toxins.

Admittedly that incident caught my attention, because for many years our law firm was located in a very similar 20- story building owned by a major client. But 1981, and even 1994, are many years ago.

My understanding changed dramatically in the Fall of 2007 as a result of a County Bar Environmental Law Committee meeting, and more specifically by a presentation by an environmental consultant working on the renovation program for the Buffalo City School System. The presenter showed photos of 8 caulk samples and asked us to "guess" the PCB content. Of course the eye can't tell; lab work showed they range from 0% to over 10% PCB-- a very effective teaching device. The presenter also noted that PCBs were used in many other products, including paint, and that these PCB-laden materials were likely to still be in place in many actively used buildings …including buildings I regularly visited. In fact these PCBs literally were in front of my nose, "Hiding in Plain Sight." (The name of the 1981 motion picture starring James Caan and filmed in Buffalo).

I started to contact various environmental consultants and attorneys in other states to learn more, and a lawyer friend in Philadelphia mentioned that in 1994 the Commonwealth of Pennsylvania experienced a fire similar to the fire in Binghamton. The damage to the Harrisburg Transportation Building, in which his law firm was located, was extensive, and the incomplete combustion of PCBs in the fire caused transformation of the caulk, paint and

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other PCB containing items into, among other things, dibenzofurens (a particularly nasty compound).

When the Commonwealth found that projected remediation costs exceeded $120 million, they hired an out-of-state renowned plaintiffs' lawyer to pursue claims against the manufacturers of PCB as well as the manufacturers of the paint, caulk, etc.. A 16-month marathon jury trial, the longest in Pennsylvania history (allegedly) ensued, which resulted in a jury verdict against Monsanto Company for $60,000,000. However, the Pennsylvania Supreme Court subsequently reversed the Trial Court decision, and ordered a new trial after eliminating over $100,000,000 in potential (punitive?) damage claims. See *Commonwealth Department of General Services, et al. v. Monsanto*, 898 A2d 590 (2006).

In July 2004, the Harvard School of Public Health issued a Report published in Environmental Health Perspective, finding that caulking and sealing material had been found to be an unrecognized source of PCB contamination in schools and other buildings across the U.S. See http://www.ehponline.org/docs/2004/6912/abstract.html.

Upon reading the Report, a concerned parent, who was a physician, contacted the school district in Westchester County where his son was in elementary school. Ultimately, tests established that in some locations, the soil outside windows of the school contained PCBs 350 times above the allowable federal limit of 50 PPM. The article in the New York Times of July 4, 2005 noted that the soil remediation could cost the District about $100,000.

Our New York State Education Department has now picked up on this issue and issued a health safety protocol for dealing with caulk. See http://www.emsc.nysed.gov/facplan/HealthSafety/PCBinCaulkProtocal-070615.html.

As a result of further discussions with various environmental consultants, I have been advised PCBs were used not only in some paints and caulks, but also in other products, including wood block floors, tile mastics and a common industrial building material called Galbestos, a coated corrugated galvanized steel panel.

After reflecting upon this information, here are a couple of preliminary observations for real estate lawyers to consider:

1. To the extent that there are representations and warranties in a sale contract for a facility that disclaim the existence of any hazardous materials (except for ordinary office supplies such as copier toners), those representations and warranties could be breached, and hence provide the purchaser with a claim for rescission or damages. In particular, when a deal craters for financing or other problems, a contract vendee might assert that it is entitled to the return of its deposit.

2. People dealing with buildings that have a public aspect, such as schools, seriously need to consider -- from both a public relations as well as legal standpoint -- including caulk, paint and other materials with PCBs in remediation specifications.

3. Similar to the treatment of asbestos-containing materials, demolition and renovation contracts may require PCB-ladened caulk, paint and other materials to be remediated before demolition in

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whole or in part so that the majority of the debris may legally be transported to a Constructional and Demolition (C & D) landfill, and the hazardous materials to a TSCA Hazardous landfill. (I have been told that in my area Western New York, the cost of transfer and disposal to a C & D landfill runs about $15/20 per ton while a full "D" landfill with a liner is approximately $35-$45 per ton.) Query: will dumping records for C&D landfills provide class action liability claims if significant PCB leachate contamination affects adjacent properties or community water supplies?

4. Clients owning older buildings with PCBs in place, including caulk and paint, may have serious exposure to significant future cleanup costs that far exceed the insurable value of the building if they have a relatively small fire that does not totally destroy the building. In a related example, one insurance-consultant friend who has a long history of managing environmental risks with nationally based insurance and risk-management companies, mentioned that a school system in a Western state with which he was currently working requested third-party casualty-risk insurance on the amount of $100,000,000 to try to protect against future liability arising from a former industrial property the school system was purchasing (for a much smaller price) for construction of a large school.

Anecdotally, I have the sense that state and local officials vary significantly in their knowledge about this issue as well as the degree of concern for enforcement. Some, who would routinely require asbestos abatement before demolition, apparently will allow demolition of buildings with nonfriable paint and caulk to proceed without abatement. Also anecdotally, I believe that two of the most knowledgeable groups dealing with this issue are environmental consultants and major construction contractors (as friends in both businesses have told me, "I am surprised more lawyers haven't heard about this.")

I would be interested to learn whether other ACREL members have encountered this problem. ■

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

Court Rejects Sale/Leaseback Scheme With Distressed Homeowner

by Harris Ominsky, Philadelphia, PA

Courts will scrutinize schemes intended to take advantage of distressed homeowners. In a recent case the Court challenged the language in a sale/leaseback agreement with defaulting homeowners and analyzed the transaction in a way that curtailed an attempt to evict them.

The Court's action falls under the rubric of "recharacterization" of an agreement into something other than how it had been labeled by the parties. In that case it meant that a document labeled a "lease" to the homeowners was held to be an "equitable mortgage," which meant that the homeowners' interest in the property could be terminated only through a foreclosure action. *Bernstein v. New Beginnings Trustee*, *LLC,* 988 So. 2d 90 (Fla. App. 2008).

A company, ironically calling itself "New Beginnings," approached the Bernsteins, homeowners who had fallen behind in their mortgage payments due to illness and were facing foreclosure on their property. The accelerated claim of the mortgage balance, including interest and costs was $89,000, but the mortgage gave the Bernsteins the right to cure and reinstate the mortgage for $32,000. According to the Court, their property was worth $250,000.

A few weeks before the foreclosure, New Beginnings bought the property for $32,000, and agreed to pay that sum to the lender to reinstate the defaulted loan. Also, it gave the Bernsteins a one-year lease with an option to repurchase their home for $125,000.

Lease Terms

The other part of the transaction was the one-year leaseback to the Bernsteins. They were to make rental payments of $1100 a month that would be applied to the mortgage by New Beginnings. Any excess over the required mortgage payments would be retained by it to cover administrative and overhead costs, and for the time and efforts of New Beginnings.

Under the lease, the Bernsteins undertook all responsibility for maintaining and repairing the property, including structural repairs. They were also responsible for special assessments, insurance, taxes and condo association fees. As the Court concluded, New Beginnings did not have "any financial responsibilities whatsoever" for the property, which it "purchased" from the Bernsteins.

The Bernsteins had deeded the property to New Beginnings, but apparently it never recorded the deed or notified the lender of the transfer. Perhaps it didn't record because that transfer could have given the lender a right to accelerate under the due-on-sale clause. Also, there was no settlement statement, title insurance, or tax and insurance prorations, as are customary in an ordinary sale.

The documents acknowledged that the sale price might not reflect the market value of the property, because the sale was at a "distressed" price. Also they stated that the Bernsteins were not acting under duress and that the transaction was "at arms length." At the trial, although the Bernsteins acknowl-

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edged that they had full knowledge of their actions and had the advice of legal counsel, they alleged that the lawyer given to them was counsel to New Beginnings.

New Beginnings alleged that the Bernsteins failed to pay the applicable "rent," but the Bernsteins responded that since New Beginnings failed to make the agreed mortgage payments, they paid the rent directly to the lender. The trial court then held that the sale and leaseback were valid, awarded partial summary judgment to New Beginnings and granted it a writ of possession of the property.

That decision did not stand up on appeal. The appeals court reversed and remanded the case for further proceedings. It held that "all indicia of ownership" remained with the Bernsteins, and they were never even required to give New Beginnings a set of keys. Since the transaction was recharacterized by the appeals court as an equitable mortgage, the Bernsteins' interest in their home could be terminated only through a foreclosure procedure. This decision means that the summary proceedings to obtain a writ of possession could not be pursued and that presumably, other legal protections provided for mortgage borrowers would have to be honored.

Analysis

In effect, the Court held that if it looks like a duck, flies like a duck and quacks like a duck, it is a duck. The self-serving language in the documents did not carry the day for New Beginnings. The transaction "was clearly not an ordinary real estate transaction." It was in fact a disguised mortgage, and no matter what New Beginnings called itself, it was a "lender."

Assuming the property was worth $250,000, here's a summary of the potential profit if it had been viewed as a "sale": The Bernsteins would have "sold" their home for $32,000 which is substantially less than the value, and they were then given the right to "repurchase" their own home for the option price of $125,000. Even if they were able to buy it back within the designated year, they would still have lost $93,000 (disregarding interest factors and other expenses).

Viewed as a loan, the transaction gave New Beginnings a return of around 300% on the $32,000 it "loaned" to the Bernsteins. Aside from potential usury issues, the Bernsteins' lawyer argued that the recharacterization would make the loan a consumer credit transaction secured by their primary residence. Therefore New Beginnings could have violated the Federal Truth in Lending Act and Regulation Z, entitling the Bernsteins to both a right to rescind and damages.

Of course, the original determination by the trial judge was a summary judgment, so the facts have not yet been tried. It remains to be seen whether the Bernsteins will prevail on their allegations of the asserted facts, including the alleged values. However, it seems that New Beginnings will have a difficult time achieving any quick remedies here.

Despite all the "indicia of ownership" retained by the Bernsteins, one factor not mentioned in the decision, would seem to militate against recharacterizing the $32,000 "purchase price" as a "loan." The way the deal was structured, the documents did not specifically require that the $32,000 loan ever be repaid, or that the Bernsteins exercise the repurchase option of $125,000. Those factors may have been down played in the Court's analysis because it may have viewed the deal as setting up an "economic compulsion" for the Bernsteins to exercise the repurchase option in order to save their home.

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It is not clear whether the Court would have still recharacterized the transaction as a loan if New Beginnings had given up some of the "indicia of ownership" in drafting the documents. Suppose, for example, New Beginnings were given a set of keys to the property and had assumed some of the financial responsibilities of ownership that were left with the Bernsteins during the one- year lease term, such as maintenance obligations, and paying insurance payments, taxes or condo fees.

We are living in an era where foreclosures are escalating all over the country. Political leaders, public agencies and businesses are instituting many kinds of valid and creative rescue plans. However, the *New Beginnings* case should be viewed as a lesson for these businesses and their attorneys that courts may not enforce legal documents merely on the basis of how they are labeled.

Homeowners should be cautioned that without good advice they should not permit themselves to be wooed by companies that come to save them with names like "New Beginnings." ■

Dear Editor:

I enjoyed the article by Harris Ominsky in the latest issue of ACREL news. He used a coin flip to decide a complex dispute among two partners. His innovative method may be more effective than we expect.

Years ago, we used a similar concept to resolve a potential partition of a very valuable ranch that had been inherited by three family members, a brother and two sisters. The brother lived on the ranch and operated it and the two sisters lived out of state. They all hated each other. It looked like the case was headed for a long, expensive and nasty partition. We represented one of the sisters. We came up with another idea and eventually they all agreed. We hired a surveyor and an appraiser and told them to divide the ranch into three parcels of roughly equal size and value. Given the size and complexity of the ranch, it was impossible to come up with three exactly equal parcels so we also allocated payments between the parcels to equalize the values. We also created reciprocal easements and other rights to ensure that all three parcels had equal access to roads, water, utilities, etc. We negotiated and finalized all of the necessary agreements.

We then identified each parcel by a color (the 'red" parcel, the "blue" parcel and the "green" parcel) and put three pieces of paper with these names on them into a hat and had a drawing with an independent person who they all trusted holding the hat. It worked really well. Later, they all thanked us for the idea and for saving the time and expense of a long and protracted litigation. Eventually, the brother bought out the two sisters and everyone was happy.

I think lawyers serve their clients best when they are willing to think outside the box and create solutions that resolve disputes and minimize litigation. Hat's off to you, Harris!

Larry Preble, KUD International, LLC, Palm Desert, CA

Electronic Documentation in Real Estate Law

by Paul J. McNamara, Masterman, Culbert & Tully LLP

I. INTRODUCTION

While real estate law contains various characteristics that reflect its historic origins, lawmakers have recently made three attempts to modernize this area of jurisprudence to enable individuals to utilize technological innovations and advances. Such legislation attempts to increase the efficiency and cost savings of conducting real estate transactions while still adhering to the rationale that underlies current real estate law. These legislative initiatives do not alter matters of substantive law, such as contract formation and interpretation; but rather they simply expand existing definitions and conceptions so that electronic documents and signatures are afforded the same legitimacy as their non-electronic counterparts. The following provides a brief overview of the three major pieces of legislation regarding electronic documentation and their significance to the real estate industry.

II. CURRENT LEGISLATION

A. Uniform Electronic Transaction Act

In 1999, the National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the Uniform Electronic Transactions Act (UETA) and presented it to the states for consideration. Currently, forty-six states, the District of Columbia, and the U.S. Virgin Islands have adopted a version of UETA.[1]

UETA grants most electronic documents and signatures the same legal status given to traditional paper documents and print signatures. This act prescribes that an electronic document or signature may not be denied legal effect or enforceability solely by virtue of its electronic nature. An electronic document, signature, or notarization satisfies state laws that generically require a document to be written, signed, or notarized. Notwithstanding, UETA expressly does not trump substantive laws that require a document to be posted, displayed, or formatted in a certain manner when such specifications cannot be complied with through electronic means.

Moreover, UETA only authorizes the use of electronic documents and signatures in transactions between two or more persons conducting business, commerce, or governmental affairs who have *agreed* to use electronic means. This act does not apply to the creation and execution of wills, codicils, or testamentary trusts, or transactions governed by the Uniform Commercial Code other than Articles 2 and 2A.

Accordingly, UETA enables individuals to conduct real estate transactions electronically. However, the drafters' comments emphasize the distinction between a real estate document's effect and enforceability between the contracting parties and its effect and enforceability with respect to third parties. There has been considerable debate regarding whether UETA authorizes documents to be electronically recorded with a county registry of deeds. On the one hand, it is unclear whether existing legacy laws and recording requirements constitute specific dis-

[1] http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ueta.asp. See **Exhibit A** attached hereto for a complete list of states that have adopted UETA.

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play, delivery, and formatting requirements that are outside the scope of UETA. Nevertheless, UETA contains optional provisions that enable a state to adopt electronic filing systems, but such provisions are expressed in very general language. Approximately 40 county recorders have implemented electronic recording systems on the basis of UETA.

B. Electronic Signatures in Global and National Commerce Act

In 2000, the federal government enacted the Electronic Signatures in Global and National Commerce Act (E-SIGN), which is modeled on UETA.[2] E-SIGN provides, in general, that electronic signatures be given the same force in law as those done with ink on paper. It eliminates legal barriers to using electronic technology to create and sign contracts, collect and store documents, and send and receive notices and disclosures. E-SIGN preempts state laws that deny the effect and enforceability of an electronic document or signature based solely on its digital nature. States can only avoid this federal preemption by adopting UETA or some other similar legislation that enforces the validity of electronic documents and signatures. Consequently, E-SIGN ensures the widespread recognition of electronic documents and signatures as an acceptable medium through which to carry out transactions.

Like UETA, E-SIGN does not obligate private individuals to use or accept electronic documents or signatures. For example, electronic notice to a consumer is only acceptable if the consumer has consented to this digital form and has demonstrated that he or she can access the electronic information. Furthermore, this federal legislation does not apply to the following: the creation and execution of wills, codicils and testamentary trusts; adoptions, divorce or other family law matters; notice of cancellation or termination of utility services or the default, acceleration, repossession, foreclosure or eviction under a credit agreement secured by, or a rental agreement for, the primary residence of an individual; the cancellation or termination of health or life insurance benefits; and the recall or notification of a material failure of a product. In other words, all bad news must still be delivered in writing on paper.

Moreover, both E-SIGN and UETA are technologically neutral and do not require the use of specific security measures to protect electronic information. Under the current legislation, people are free to use asymmetric cryptography or less sophisticated measures like passwords or pin numbers.

E-SIGN contains three specific provisions that are pertinent to the real estate industry. The first states that "loan(s) secured by real property" may be authorized with a digital signature. Additionally, this act also removes the requirement for a stamp, seal, or similar embossing device when notarial functions are performed by electronic means. Notarization requirements are satisfied if an electronic notarization, together with all other information required to be included by law, is attached to or logically associated with the signature or record. Finally, while E-SIGN preempts contrary state law, it explicitly does not preempt a state regulatory agency's authority to promulgate specific standards and formats for documents that are to be recorded with such an agency as long as those standards and formats do not impose unreasonable costs on the acceptance and use of electronic records. There has been a good deal of discussion regarding

[2] 15 USC § 7001 et seq. (2002)

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whether this provision excludes county recorders from the gamut of E-SIGN because the term "state regulatory agency" is not defined in the act, and it may be difficult to fit county recorders within the category.

C. Uniform Real Property Electronic Recording Act

In 2004, NCCUSL promulgated the Uniform Real Property Electronic Recording Act (URPERA) to address both the uncertainty of UETA and E-SIGN's effect on electronic recording and the fragmentation that has arisen as a result of some county recorders implementing electronic recording systems on an ad hoc basis under UETA and/or E-SIGN. URPERA has currently been adopted by eighteen states and the District of Columbia.[3]

URPERA clearly establishes that an electronic document satisfies any recording statute requirements for a document to be an original, be on paper, or be in writing. Moreover, an electronic signature is sufficient to satisfy any requirement that a document be signed and notarized before it can be recorded. A physical or electronic image of a stamp, impression, or seal need not accompany an electronic signature. Thus, URPERA explicitly extends the principles articulated under UETA and E-SIGN to the realm of recording real estate documents with a local registry of deeds.

NCCUSL acknowledges that each state's unique real estate and recording systems inhibit a uniform act's ability to prescribe specific guidelines and procedures, and thus URPERA is meant simply to provide a general structural starting point and common ground for the states' local registries to transition to an electronic recording regime. As a result, URPERA does not *require* county recorders to implement electronic filing systems, but rather it details certain features that recorders may implement if and when they choose to adopt an electronic recording system. For example, a county recorder may receive, index, and archive electronic documents; may provide electronic means to search and retrieve documents and information; may convert newly accepted or currently archived paper documents into electronic form; and may electronically accept any associated fees or taxes. While the foregoing features are discretionary, county recorders are required to continue to accept paper documents and to place both paper and electronic documents in the same index. The Reporter's Notes observe that the usefulness and efficiency of an electronic recording database will be impaired unless documents currently archived in paper form are also converted into electronic form. However, such a conversion will require a significant amount of time and expense.

Furthermore, URPERA also creates an Electronic Recording Commission or some other such entity to establish state-wide standards for electronic recording systems. Therefore, while URPERA provides a general uniform framework for electronic recording regimes, each state will develop its own unique standards regarding the actual receipt, recording, and retrieval of electronic documents. The drafters proffered an illustration of the type of issues that state or local commissions will have to resolve when they posed a hypothetical exploring the possibility for individuals to electronically submit documents for recording 24 hours per day and seven days per week. The state or local commission will have to

[3] http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-urpera.asp. See **Exhibit B** attached hereto for a complete list of states that have adopted URPERA.

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determine whether the document is deemed recorded when it is electronically submitted to the registry or when a local employee arrives to process and index the recording.

III. CONCLUSION

Although UETA, E-SIGN, and URPERA will not result in a complete and immediate transition to entirely paperless real estate transactions, lawyers and others in the real estate industry are now able to maximize efficiency and savings by using digital signatures, on-line signing rooms, and electronic recordings. While there are still a number of issues that will need to be addressed, there are strong and influential sources at work to modernize the way in which real estate business is conducted. The pressure for change will probably remain slightly ahead of the available technology, but ultimately the digital, digitalized, typed, or clicked signature on an electronic document will be as commonplace as ink on paper. ■

Exhibit A:
State Adoptions of Uniform Electric Transactions Act

Alabama	Indiana	Montana	Rhode Island
Alaska	Iowa	Nebraska	South Carolina
Arizona	Kansas	Nevada	South Dakota
Arkansas	Kentucky	New Hampshire	Tennessee
California	Louisiana	New Jersey	Texas
Colorado	Maine	New Mexico	U.S. Virgin Islands
Connecticut	Maryland	North Carolina	Utah
Delaware	Massachusetts	North Dakota	Vermont
District of Columbia	Michigan	Ohio	Virginia
Florida	Minnesota	Oklahoma	West Virginia
Hawaii	Mississippi	Oregon	Wisconsin
Idaho	Missouri	Pennsylvania	Wyoming

Exhibit B:
State Adoptions of Uniform Real Property Electronic Recording Act

Arizona	Florida	Nevada	Texas
Arkansas	Idaho	New Mexico	Virginia
Connecticut	Illinois	North Carolina	Washington
Delaware	Kansas	South Carolina	Wisconsin
District of Columbia	Minnesota	Tennessee	

Transfers to Trusts or Limited Liability Companies – What are the Title Risks?

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

A trust or a limited liability Company ("LLC") often is used as an estate-planning vehicle, with the transfer of real property to the trust or the LLC. But special care must be taken to avoid termination of coverage under the Owner's Policy of Title Insurance. For example, in *Gebhardt Family Restaurant, L.L.C. v. Nation's Title Ins. Co. of New York*, 132 Md. App. 457 (2000), the court held that a transfer of land from two family members to an LLC, of which they were the only members, terminated coverage under a policy naming the individual family members as the insured parties. The Gebhardts, husband and wife, owned a 31.7-acre parcel of property, upon which they held an Owner's Policy of title insurance. In 1995, they discovered that another party was paying property taxes on 4.75 acres of the property. They submitted a claim to the title insurer, demanding that the insurer correct the situation by "negotiating a purchase from the alleged owner (who also has a cloud on title) . . . and obtaining a quitclaim in favor of [the Gebhardts]." *Id*. at 459. In 1996, before the claim was resolved, the Gebhardts executed, for estate-planning purposes, a special warranty deed conveying all of the property to a Virginia LLC of which they were the sole members. The deed recited a consideration of approximately $161,000.

In 1997, the Gebhardts sued the title insurer for breach of contract for failing to resolve the title dispute. The sole issue before the court was whether the Gebhardts or the LLC were the insured party under the policy. At the trial, Mr. Gebhardt testified that in fact no consideration changed hands (despite the deed recitation of consideration in the amount of $161,000), and that the only reason for the deed recitation was so that the State of Maryland could "assess the transfer taxes from the individual to the L.L.C." *Id.* at 460. The Maryland appellate court stated that "there is no dispute" that the Gebhardts did not remain insureds under the title policy by virtue of a purchase money mortgage or by virtue of covenants of warranty. *Id*. at 462. (The Conditions and Stipulations of The standard ALTA Owner's Policy of title insurance policy contain a provision providing that coverage under the policy continues if the insured retains an estate or interest in the land, holds a purchase money mortgage from the purchaser, or retains continuing liability by reason of deed covenants of warranty). The Gebhardts also conceded, at oral argument before the appellate court, that the LLC had not acquired title by "operation of law." (The policy definition of "insured" includes "those who succeed to the interest of such insured by operation of law as distinguished from purchase").

The Gebhardts argued that they nonetheless remained insured parties under the title policy because the conveyance was, in effect, to themselves, and therefore they still retained an "interest" in the property. However, the appellate court ruled that "[i]n contrast to a partnership, a limited liability company in Virginia is an entity separate from its members and, thus, *the transfer of property from a member to the limited liability company is more than a change in the form of ownership; it is a transfer from one entity or person to another* (emphasis in text) (citation omitted)." *Id.* at 463. The court held that while the Gebhardts had an interest in the LLC (which was a personal property interest), they no longer had an interest in the real property as the result of their conveyance of the property to the LLC. The court also rejected the Gebhardts' claim

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that there was no "real" conveyance because the LLC in fact paid no consideration, ruling that the conveyance to the LLC provided the Gebhardts with actual and substantial benefits, including limited liability and estate planning benefits. The court found that the Gebhardts' argument was "circular," i.e., a valid conveyance had occurred because a transfer tax is imposed on the transferring of property and if there had not been a conveyance, no transfer tax would have become due.

The court also noted that as the result of conveying by special warranty deed, the Gebhardts covenanted to protect the LLC only against claims made "by, through, or under" the Gebhardts, as grantors, and did not warrant title against someone else. Therefore, the court held, the Gebhardts had transferred to the LLC the unresolved title claim, and the LLC became the proper party to defend any action by another party to quiet title (with no recourse against the Gebhardts as grantors). Finally, the appellate court rejected the Gebhardts' assertion that they had suffered a loss under the policy, and reported it to the title insurer, before the conveyance to the LLC. The court noted that the Gebhardts had admitted in their appellate court brief that no actual loss had yet occurred. The court held that because of the conveyance to the LLC, which was a legally distinct entity, any subsequent loss would be the LLC's loss, which entity was not the insured party under the title policy either before or after the conveyance.

In a recent ruling that reached a result similar to that of the court in the *Gebhardt* case, *supra*, the California appellate court, in *Kwok v. Transnation Title Ins. Co.*, --- Cal. Rptr. 3d ---, 2009 WL 311444 (Cal. App. 2 Dist, Feb. 10, 2009), affirmed the trial court's summary judgment in favor of the title company. After the title policy was issued to an LLC (of which plaintiff and his wife were the sole members), the property was transferred by a grant deed from the LLC to plaintiff and his wife as trustees of a revocable trust. An easement dispute with a neighbor resulted in plaintiff and his wife filing a lawsuit, and the neighbors filed a cross-complaint. These actions were tendered to the title company under the policy, but the title company denied coverage "on the grounds that the transfer of the property by the LLC to appellants as trustees was a voluntary act that did not arise by operation of law and therefore terminated coverage." *Id*. at *2. The title company also advised the plaintiffs that they had failed to avail themselves of "an available endorsement for coverage after transfer of the property to a separate legal entity." *Id.* The appellate court upheld the decision of the trial court, finding that "It is undisputed that the LLC is the only named insured on Schedule A of the policy and that appellants did not obtain an endorsement adding their revocable family trust as an insured." *Id.* at *3. The court ruled that coverage did not continue because title to the property was not transferred to plaintiff and his wife as members of the LLC upon dissolution of the LLC, but instead was transferred by deed from the named insured plaintiff to plaintiff and his wife as trustees of their family trust, a totally separate legal entity.

The appellate court rejected the plaintiffs' argument that the grant deed was "merely a means to put the public on notice that they now held title to the property as trustees," because the property was transferred by deed from the LLC to the plaintiffs as trustees of a family trust, and not to the members of the LLC in their individual capacities upon dissolution of the LLC. The appellate court also noted that there was no evidence to support the plaintiffs' assertion that they continued

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to hold that same proportional interest in the property after the transfer that they held as members of the LLC. The court further noted that as members of the LLC, they never held individual ownership interests in the property, which was owned by the LLC a separate legal entity. The court also held that the plaintiffs did not succeed as insureds under the Owner's Policy because "[t]here is nothing in the policy definition of 'insured' that identifies 'beneficial owners' as insureds . . . The transfer of property by an insured into a family trust is a voluntary act and not one that arises by operation of law." *Id.* at*6.

The court further rejected the plaintiffs' argument that they were "distributes" under the title policy provision defining "insureds" because they paid no transfer tax on the deed from the LLC to the trust and no money changed hands, and therefore they did not actually purchase the property. The court pointed out that a transfer can occur that does not involve a purchase (e.g., a transfer of property by gift), "but nevertheless does not arise by operation of law."

With respect to transfers to trusts, see *Covalt v. First American Title Insurance Co.*, 105 F.3d 669, 1997 WL 4273 (10th Cir. Jan. 7, 1997) (unpublished disposition). In this case, the court ruled that the transfer of real property, by quitclaim deed, from an individual to a trust in which the individual retained an interest, prevented the trust from claiming any rights under the title insurance policy originally issued to the individual. Similarly, in *Austin v. City of Alexandria*, 265 Va. 89, 95-96 (2003), the court ruled that a deed to a trustee effects a change in ownership of property even if the grantor, trustee, and beneficiary are the same person and the beneficiary has complete power to revoke the trust.

As noted above, the title insurer will likely reject a claim by a party who is neither the insured named on Schedule A nor a "successor" thereof by "operation of law." A more prudent course of action for a trust or an LLC, to which real property has been transferred as part of an estate plan, may be to obtain a new owner's title policy at the time of the conveyance. The trust or LLC would clearly become the insured party, the status of title would be identified and insured through the date of closing, the validity of the transfer would be insured, and the property would be insured for its current value. However, obtaining a new owner's policy may be expensive (although a reissue rate may apply).

The best solution (as noted by the court in the *Kwok* case, *supra*) may be for the grantee trust or LLC to request an "additional insured" endorsement from the title insurer (in those jurisdictions where it is available), which would be effective as of the date of the conveyance. This endorsement specifically amends the existing Owner's Policy of title insurance to add the trust or LLC as a named insured. The cost of the endorsement is usually nominal and many title insurers will routinely issue the endorsement for successor LLCs as well as for trustees for inter vivos trusts, who are acquiring title from the insured owner(s). However, the coverage provided by the additional insured endorsement is no greater than that provided under the original policy, and is subject to all the defenses available to the title insurer under the original policy. For example, there is no protection for the additional insured if the conveyancing deed is itself defective.

Under the new 2006 ALTA Owner's and Loan policies the definition of "Insured" contained in Condition 1(d) (in the 2006 Owner's Policy) and Condition 1(e) (in the

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Transfers to Trusts or ...

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2006 Loan Policy) has been expanded and is a significant improvement over the 1970 and 1992 ALTA Policies. A policy of title insurance protects, for the most part, only the named Insured in the policy. As noted above, under the 1970 and 1992 Policies, with little exception, those who succeed to the interest of the property by operation of law, as opposed to voluntary conveyance, also fall within the definition of "Insured." However, determining what is a voluntary transfer, as opposed to a transfer by operation of law, has resulted in substantial confusion and uncertainty. The new definition of "Insured" in the 2006 Owner's and Loan Policies more clearly defines the term and recognizes certain "voluntary" conveyances by the named Insured that are made without receipt of valuable consideration, including, in the Owner's Policy, where the grantee is the trustee or beneficiary of a trust established by the named Insured for estate-planning purposes. ■

ACRELades

James P. McAndrews has had the second edition of his book, "Commercial Real Estate Law Practice Manual with Forms" published by the General Practice Section of the American Bar Association.

Jesse Smith of San Francisco was awarded the Lambda Alpha International, Golden Gate Chapter, Member of the Year award for 2008. The award was given for, in part, "his contribution to development projects that have transformed the City, including the Giants Ballpark, Mission Bay, Westfield Center, and the conversion of the Hunters Point Shipyard and Treasure Island military bases."

Best Lawyers has named the following Real Estate Lawyers of the Year for 2009: **Donald U. Beimdiek -** St.Louis , **William E. Carr** – St. Louis, **Charles S. Ferrell** – Minnesota, and **Robert J. Krapf** – Delaware. [*On the list for another location? Let us know*!]

Right of First Refusal May Impair Family Gift

by Harris Ominsky, Philadelphia, PA

One of the most commonly disputed real estate transactions is the right of first refusal to purchase a property. A recent case dealt with whether a transfer of property to the sellers' son for substantially less than its fair market value was a "sale" which triggered the option holders' first refusal right to purchase that property for the bargain price.

That issue arose in a case where the original owners conveyed property to a married couple named Duenke. In connection with that sale, the Duenkes gave their grantors a right of first refusal to purchase the property. That right was recorded, and sixteen years later, despite an appraisal, which valued the property at $125,000, the Duenkes conveyed the property to their son for $85,000. Several years later, the son listed the property for sale at $250,000. When the option holders noticed the "For Sale" sign, they checked the public records, and discovered the earlier conveyance to the son. The option holders sued to upset the conveyance because the Duenkes had bypassed their right of first refusal when they sold the property to their son, and didn't honor their right to purchase the property in 1996.

At the trial on that issue, the court found that the transfer to the son did not trigger the right of first refusal because it was "an intra-familial" transfer akin to a gift, and was not based on a "bona fide offer" as stated in the right of first refusal. That's because (1) the Property was not listed for sale on the open market; (2) [the Duenkes] accepted whatever [the son] could afford; and (3) they accepted a price that was below fair market value so as to keep the Property "in the family." *Schroeder v. Duenke,* 2008 Westlaw 3844741 (MO. App. 8/19/08).

Court of Appeals

On the issue of whether the transfer was a "akin to a gift," the Missouri Court of Appeals reversed the lower court, and held that although a transfer by gift from one family member to another does not trigger a right of first refusal, generally a gift is defined as a transfer without any consideration or compensation as an incentive or motive for the transaction. It then stated that based on the facts of this case and an earlier precedent, the transfer to the son did not appear to be a gift on the face of it because the son had financed $60,000 of the purchase price. Also, he had paid $85,000 consideration for the property to his parents, and the warranty deed to the son specifically stated it was in exchange for valuable consideration.

Despite that, the Court denied the Duenkes' Motion for Summary Judgment. Rather it concluded that the case should be remanded to the trial court on the issue of whether the son's offer of $85,000 for the property was a "bona fide offer." On this issue, the Court noted that the law does not require the property to be placed on the open market, and the fact that the parties intended to keep the property in the family has no bearing on the question.

The Court cited another element: a bona fide offer must be based on fair market value, which is a determination ordinarily made by the finder of fact. Since the 1996 transfer to the son was at a price $40,000 less than the appraised value, that could be a factor which would lead to the conclusion that the price was not based on fair market value.

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The court stated:

Based on the foregoing evidence, whether or not the offer in this case was based on the Property's fair market value must be determined by the finder of fact. The fact that Harold and Eleanor Duenke wanted their son to have the Property and priced it to what he could afford does not necessarily preclude a finding that the price offered was based on the Property's fair market value. The evidence suggests and common sense dictates that the price was set with at least some reference to its fair market value or, in Respondent's words, "what ground was bringing" in the area. The parties specifically sought out a determination of the Property's fair market value by way of obtaining an appraisal on the Property just weeks before the sale, which supports the inference that they used the fair market value to arrive at the price Respondent would pay. Moreover, the testimony that Harold and Eleanor Duenke would not have sold the Property to a third party, even for the appraised value of $125,000, establishes only that they did not want to sell the Property to anyone other than their son; it does *not* establish that Respondent's offer to purchase for $85,000 was not based upon the fair market value.

Unexpected Windfall

Other cases have held that a refusal right, which is intended to be triggered by a "bona fide offer", does not necessarily contemplate that the sale be for fair value.

The concept that a "bona fide offer" must be based on "the fair market value" of the property raises issues of determining the intent of the parties to the sale. That may not always be easy to determine. For example, suppose the seller is trying to give the buyer a break because the seller is trying to pay the buyer back for some favor or kindness shown to the seller by the buyer. Would it make a difference if the buyer doesn't know that she is getting a sweetheart deal based on an appraisal that has been given to the seller? Does that make the buyer's offer any less bona fide? Suppose the seller offers the property at a favorable price because the seller has a romantic relationship with the buyer, or just likes the buyer. Would that make the buyer's offer any less bona fide?

In drafting the language of a first refusal right, the parties must be careful to define the kind of sale that triggers that right. If on the one hand they don't specifically exclude gifts or charitable donations of the property, the option holder may receive an unexpected windfall by getting the property for nothing, or practically nothing. If on the other hand, language is used to define a triggering sale as excluding any sales at less than the "fair market value," the grantors of the right of first refusal can circumvent or negate that right by excluding any sales where they want to do someone a favor by selling at a low price for either business or non-business reasons that will often be difficult to sort out in a court of law.

In drafting these rights of first refusal, careful thought must be given to the issues raised in the *Duenke* case; and it may help to review those clauses drafted in the author's book, *Real Estate Lore - Modern Techniques and Everyday Tips for the Practitioner* (ABA, 2005), pages 347 to 350. As illustrated in this case, the term, "bona fide," without clarification, is an invitation to litigation.

In this case it seems that one way the Duenkes could have avoided the issue of triggering the right of first refusal was by giving the property to their son as a gift for no payment. If they wanted their son to repay them, they might have worked out some more creative way than through a purchase price on a "sale." ■

Fellows Host Regional Gatherings

by Earl Segal, Newmark Knight Frank, Washington, DC

ACREL fellows in several regions of the country have discovered that collegiality among fellows need not be limited to ACREL's twice a year meetings. Over the past year there have been regional and local dinner and lunch meetings, happy (you remember "happy") hours, as well as a golf outing, all well attended by ACREL fellows. The gatherings have been for purposes including the welcoming of new ACREL fellows in the region; the identification of potential new ACREL fellows; the sharing of recent developments in the practice of real estate law; and simply for the purpose of getting together with friends. There is no official structure for the planning of these gatherings and if you would like to have one in your region you have the opportunity to create something as simple or elaborate as you wish. Scheduling the gathering about midway between the two national meetings has proven successful in the past. Please take the opportunity to reconnect with friends and enjoy some of the best benefits of ACREL fellowship. If you are interested in organizing a gathering please contact ACREL President, Phil Weller at phil.weller@dlapiper.com. You might even be able to get Phil to attend. ■

New on the Web – ACREL Mobile Site!

You may now get to a streamlined version of the ACREL website from your BlackBerry, cellphone or other PDA. Simply log onto http://mobile.acrel.org from your mobile device, and browse Fellows, meetings and other information. Or log onto the private site, www.acrel.org and look in the black box at the upper right of your screen for handy links to have the site sent directly to your mobile. If you forget the URL while traveling, you may also use the "ACREL Mobile site" link from your mobile to redirect your device to the mobile site. In addition, you may now download v-cards for members from the site to your mobile, your laptop or your desktop.