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MESSAGE FROM THE SECTION CHAIR

Greetings, and I hope that you all had a wonderful summer.

All members of the Section should have received a communication from me enclosing a letter from the Executive Director of the Office of Real Property Services, Thomas G. Griffen, on the STAR (School Tax Relief) exemption. This letter generated a number of inquiries and a discussion on exemptions generally—when they are lost and the restoration provisions. The Executive Committee decided this would be a good topic for an article for the *Journal* and you should look for that in the next issue. In the meantime, Mr. Griffen's letter was designed to alert you to an issue and, in particular, to give a suggestion as to how to handle the enhanced STAR exemption available to senior citizens. I urge all of you, of course, to study

the statute, application forms and informational materials being circulated as you represent clients in this area.

While communications to the membership as described above are a cost to the Section, I believe that on occasion we need to inform our members of timely issues in this manner. So that we have our records up to date, if you have not already done so, please forward your facsimile number and, if available, e-mail address to:

New York State Bar Association
Attention: Records Department
One Elk Street
Albany, New York 12207
Fax (518) 487-5517

Please confirm to them that you are a member of the Real Property Law Section.

Our summer meeting in Cooperstown was a tremendous success, replete with fine weather, a superb program and even an exciting evacuation of The Otesaga for a few minutes! The first day's

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session involved lawyers and technology, and included helpful presentations by Robert Blumberg, Albert DeGregoris, Michael Winner, Don Nieman, Ralph Weidler and Leonard Sienko. There was also a very interesting panel discussion moderated by John Hall on "The Year 2000 Computer Crisis," with panelists Charles Reynolds, Eric Haas, Paul Reddy and Ronald Feldman. The second day involved current issues in real estate financing with excellent presentations by John Blyth, Karl Holtzschue, Peter Coffey, Larry Preble, Dorothy Ferguson, Joshua Stein, K.C. McDaniel, Joseph Ball and Harold Hanson. We also were treated to dueling piano performances with John Blyth and Dorothy Ferguson "strutting their stuff"! Our dinner speaker Saturday evening was John Tierney, columnist for the *New York Times Magazine*, who gave a humorous and provocative talk. Our special thanks and gratitude go to Steve Horowitz, Program Chair, all of the presenters and our fine sponsors, whose financial assistance is most appreciated—Chicago Title Insurance Company; Commonwealth Land Title Insurance Company; First American Title Insurance Company; Marine Midland Mortgage Corp.; McNamee, Lochner, Titus & Williams; Monroe Abstract and Title Corporation; and Sneeringer Provost Redgrave Title Agency, Inc.

Let me conclude with two corrections from the prior Message from the Section Chair. The first is that I attributed the model subordination, non-disturbance and attornment form and report to the Real Estate Financing Committee, instead of the Commercial Leasing Committee, whose subcommittee, chaired by Joshua Stein, produced that excellent work. The other correction involves a grammar no-no — did you spot it? I will discuss it in the next *Journal* as it brought to mind the importance of having a mentor.

Best wishes and enjoy this very special time of year in the Northeast.

Lorraine Power Tharp

"Due-On" Clauses: Are They Enforceable?*

by John E. Blyth**
Rochester, New York

I. Generally

"Due-on" clauses generally refer to due-on-sale, due-on-transfer and due-on-encumbrance clauses. Under various guises, they afford the mortgagee the right to accelerate the mortgage debt and to foreclose the mortgage if the mortgaged real property is transferred without the consent of the mortgagee.

Due-on clauses are generally enforceable as a matter of freedom of alienation or as a matter of freedom of contract[1] unless enforcement is prohibited as a matter of state law, either by state case law or by state statutory law. Even if state law prohibits the enforcement of a due-on clause, the state prohibition against enforcement may nevertheless be preempted by federal statute or regulation in the form of the Garn-St. Germain Depository Institutions Act of 1982 (hereinafter "Garn-St. Germain")[2] as supplemented by the Federal Home Loan Bank Board in its 1983 Preemption of State Due-on-Sale Laws (hereinafter "the Preemption").[3]

If the federal preemption statute or regulation does not apply, then enforceability of due-on clauses is determined by reference to state law. State law may render it automatically enforceable or may subject it to a case-by-case analysis before allowing enforcement. It is the position of this article, however, that federal preemption applies in nearly every case.

Although commonly found in commercial due-on-sale clauses, due-on-change of ownership, due-on-change of control, or due-on-change of management clauses are not considered due-on-sale clauses. Their enforceability, therefore, must be separately analyzed.

To reach these conclusions, it is necessary to plow through an awesome body of case law plus the federal statute and federal regulations. That task is made considerably easier by reference to the vast body of scholarly literature on the subject.[4] Because the literature is so voluminous and because scholars have analyzed the subject so well, many of the summary references in this article are to journal articles only, without further reference to cases and other authorities cited by the scholars. Cases are used primarily for illustrative purposes.

II. Illustrative Due-On Clauses

A. Definitions

1. Garn-St. Germain

Garn-St. Germain[5] defines a due-on-sale clause as a contract provision that authorizes a lender, at its option, to declare due and payable sums secured by the lender's security instrument if all or any part of the property, or an interest therein, securing the real property is sold or transferred without the lender's prior written approval.

2. The Preemption

The Preemption[6] defines a due-on-sale clause as a contract provision authorizing the lender, at its option, to declare immediately due and payable sums secured by the lender's security instrument upon a sale or transfer of all or any part of the real property securing the loan without the lender's prior written consent. For purposes of this definition, a sale or transfer means a conveyance of real property of any right, title or interest therein—whether legal or equitable, voluntary or involuntary—by outright sale, deed, installment sale contract, land contract, contract for deed, leasehold interest with a term greater than three years, lease-option contract or any other method of conveyance of real property interests. The only substantive difference in the Preemption's due-on-sale definition is the insertion of the word "immediately" prior to the words "due and payable."[7]

Interpretation of these definitions becomes critical in determining the applicability of Garn-St. Germain and the Preemption to specific types of sales, transfers, and encumbrances with the result that either federal preemption applies or state law applies.

B. Types

1. Residential

Clause 17 of the Federal National Mortgage Association/ Federal Home Loan Mortgage Corporation Mortgage (applying to one- to four-family homes) provides that if all or any part of the property or an interest therein is sold or transferred by the borrower without the lender's prior written consent, the lender may, at the lender's option, declare all the sums secured by the mortgage to be due and payable.[8]

2. Commercial

A standard commercial mortgage provides that the mortgagor cannot, without the prior written consent of the mortgagee being first had and obtained (which consent may be granted or denied in mortgagee's sole discretion), voluntarily or involuntarily, by operation of law or otherwise, transfer or dispose of, or suffer any third party to transfer or dispose of, all or any portion of the secured property or any interest therein or the management and/or operation by mortgagor of the secured property. For the purposes of this discussion, a transfer or disposition of the secured property or any part thereof or interest therein will include, without limitation, the sale of the secured property or any portion thereof to a residential cooperative corporation, conversion of all or any part of the secured property to a condominium form of ownership, execution of a contract to sell or option to purchase all or any portion of the secured property or any interest therein, any lease for space in any improvements on the secured property for purposes other than occupancy by the tenant, any lease for space in improvements containing an option to purchase, or any direct or indirect sale, assignment, conveyance, transfer (including a transfer as a result of or in lieu of condemnation), or other alienation of all or any portion of the secured property or any interest therein, including, but not limited to, the creation of a lien[9] or other encumbrance on the secured property or any part thereof or interest therein, and further including any assignment, pledge, grant of security interest in, conditional sale, or the execution of a title retention agreement with regard to any personalty included in the secured property. Any such action described herein is called a "transfer."[10] A transfer also includes, without limitation, any of the following events, whether made directly or through an intermediary, and whether effected through one or more transactions:

(1) If the mortgagor or any general partner of the mortgagor is a corporation, a transfer or disposition of more than ___ percent of the outstanding voting stock of the mortgagor or such general partner of the mortgagor or of any other corporation directly or indirectly owning or controlling ___ percent or more of the voting stock of the mortgagor or such general partner;[11] or

(2) If the mortgagor or any general partner of the mortgagor is a partnership, a transfer or disposition of any interest of any general partner in the mortgagor or such general partner in the mortgagor or such general partner of the mortgagor; or

(3) If the mortgagor or any general partner of the mortgagor is a trust or other entity, a transfer or disposition of more than ___ percent of the beneficial interests in the mortgagor or such general partner of the mortgagor.

For purposes of the foregoing discussion, a "transfer or disposition" of such stock or interests shall include, without limitation, a transfer by operation of law, any direct or indirect sale thereof, any execution of a contract or other agreement to sell or option to purchase such stock or interests, or any assignment of such stock or interests, including any assignment for security purposes.

C. Definition of Sale, Transfer, and Encumbrance

Although Garn-St. Germain defines a "due-on-sale clause," words like "sale," "transfer," and "encumbrance" are not defined by the act. The words "sale" and "transfer"—and presumably "encumbrance" as well—are defined by state case law.[12]

III. Reasons for Due-On Clauses

Lenders use due-on-sale clauses for four reasons: (1) to make sure that the new borrower is a good credit risk; (2) to reappraise the security property to see if it is still valuable enough to justify keeping the debt in place; (3) to bring the loan interest rate and its terms in line with prevailing market rates and terms; and (4) to reduce the volume of real estate loans in their portfolios. The third objective is so important that due-on-sale clauses are far more likely to be found in fixed rate than in adjustable rate loans, most of which are freely assumable.[13] The economic benefit to the lender is to eliminate lower interest mortgage loans from institutional portfolios.[14]

Due-on-encumbrance clauses,[15] while occasionally used for interest rate reasons, are largely intended to protect the mortgagee against an increased risk of default where second mortgage financing or subsequent liens increase the mortgagor's total debt burden and reduces his or her economic stake in the mortgaged property, especially in commercial settings.[16]

IV. Enforceability of Due-On-Sale Clauses Under State Law

A. Judicial Restraints

While due-on-sale clauses[17] generally are enforceable under state law, either under a freedom of alienation theory or a freedom of contract theory,[18] a due-on-sale clause does not itself constrain the conveyance of title but merely causes debt acceleration; accordingly, the restraint, if any, attaches to the mortgage rather than to the conveyance. The borrower's predicament is not caused by the due-on-sale clause, but rather it is caused by the borrower's inability to prepay the mortgage.[19] Attacks on their enforceability, however, began as soon as these types of clauses became prevalent.[20] California led the assault on such clauses, and the courts of at least three other states (Arizona, Arkansas, and Michigan) also restricted their enforceability.[21]

Attacks against enforceability based on a restraint of alienation theory have been particularly prevalent. At issue is whether courts would (or could) enforce such clauses, where the mortgagee's security was not threatened by a transfer of title, and whether the mortgagee could simply gain from a fortuitous event—a higher interest yield. In short, the transferee would be credit-worthy, but the lender would not approve a mortgage takeover at the original, lower interest rate.[22]

Traditionally, a *direct restraint* on alienation has been viewed as invalid *per se* unless the restraint falls within certain limited exceptions.[23] The minority view is that a direct restraint is void unless the policy underlying its purpose outweighs the degree of restraint imposed on the property interest. This view recognizes the desirability of protecting the mortgagee from the vagaries of the interest rate market. Accordingly, the validity of the clause is not normally judged by the facts of an individual case, except as may be necessary to show that enforcement is unconscionable or inequitable.[24]

Even in an automatic enforcement jurisdiction, courts often rule that a due-on-sale clause is unenforceable when the mortgagor can establish that enforcement would be "unconscionable" or "inequitable." This means that most courts will be unwilling to enforce the clauses in a "non-substantive" or "non-sale" transfer; e.g., (1) a transfer to a spouse who becomes a co-owner; (2) a transfer to a spouse incidental to a marriage dissolution proceeding or settlement; and (3) a transfer to an *inter vivos* trust of which the mortgagor is a beneficiary.[25] These non-substantive and non-sale transfers are mirrored in the nine exceptions contained in Garn-St. Germain.[26]

An *indirect restraint* is deemed valid if it is reasonable. An indirect restraint is one that arises when an attempt is made to accomplish some purpose other than the restraint on alienability, but with the incidental result that it would restrain practical alienability.[27] A due-on-sale clause is an indirect restriction on the borrower's right to sell (restraint on alienation) because it gives the lender the option of declaring all of the unpaid debt immediately due and payable unless the borrower pays off the debt before selling the property.[28] Because it may be viewed as a restraint on alienation, the clause is construed strictly against enforcement.[29]

Under the minority view of a direct restraint on alienation, a due-on-sale clause must be reasonable in individual cases, thus necessitating a case-by-case determination. The mortgagee's desire to increase interest rates is not considered a sufficient reason to justify the clause. The mortgagee has the burden of establishing reasonableness and normally must show that transfer would result in security impairment or an increased risk of default.[30] In these jurisdictions, lenders rarely seek due-on-sale enforcement.[31]

The restraint on alienation argument has always been a weak one. Those who have pressed it have usually managed to avoid direct discussion of its major premise: that mortgage lenders somehow have an obligation to finance not only the ownership of their immediate borrowers, but of the transferees of those borrowers as well. If one accepts this premise, then it is true that the due-on-sale clause is a practical restraint on alienation. On the other hand, if lenders have no such duty, then their insistence on being paid off when the borrower sells the property, or on extending the loan only at a higher interest rate, cannot be thought to restrain the sale any more than would the refusal of some other lending institution to finance the new owner's purchase.[32]

B. Legislative Restraints

Several states imposed legislative limitations on due-on-sale clauses.[33] Although they differ in details, they commonly prohibited due-on-sale enforcement in residential mortgages unless the mortgagee could establish that a transfer would impair mortgage security. Most states permitted the mortgagee to condition transfer of the property upon payment of a limited "assumption fee" or upon an increase in the mortgage interest rate by a modest amount, usually no more than one percent. Some of the statutes imposed similar restrictions on increased-interest-on-transfer provisions.[34]

V. The Federal Responses

A. Federal Home Loan Bank Board (1976)

The Federal Home Loan Bank Board (FHLBB), believing that restrictions on a lender's ability to accelerate a loan upon transfer of the security would adversely affect lenders due to the loss of cash flow, net income, and access to secondary mortgage markets, in 1976 issued a regulation that curbed state power over due-on provisions with respect to loans held by federally chartered thrift institutions.[35] The U.S. Supreme Court, in *Fidelity Fed. Sav. & Loan Ass'n. v. de la Cuesta*,[36] upheld the regulation, ruling that Congress had delegated to the FHLBB the power to preempt state law as to such institutions under its regime.[37]

B. Garn-St. Germain Depository Institutions Act of 1982

Persuaded that broader relief was necessary, Congress passed the Garn-St. Germain Depository Institutions Act of 1982.[38] This measure, and the regulations thereunder,[39] cover essentially all[40] lenders, individual and institutional (except some state-chartered and state-regulated lending institutions)[41] and all properties, residential and commercial.[42]

This federal statute applies alike in states that found such clauses an unreasonable restraint on alienation, as well as in states whose courts upheld the clauses' automatic acceleration provisions—and to the extent that some states used their contract law to invalidate the clause, this interpretation must be intended. However, the reach of the statute into a state's substantive contract law should not be further than necessary to accomplish its purposes. All contract defenses otherwise continue to apply: examples are the rules relating to the unconscionability of contracts or to contracts of adhesion.[43]

There remain, however, some key exceptions to the Garn-St. Germain coverage.[44]

1. Window Periods

The first exception created by Garn-St. Germain[45] postponed until October 15, 1985, the act's preemption of state law where a state had prohibited the exercise of due-on-sale clauses by any one of three means: a constitutional provision; a statute prohibiting the exercise of due-on-sale clauses; or a decision of the state's highest court prohibiting such exercise.[46]

The effect of Garn-St. Germain was to divide states into those with window periods and those without window periods. For states that had not prohibited the exercise of due-on-sale clauses by October 15, 1982, Garn-St. Germain precluded the adoption of such prohibitions, and its application was complete. For states that had prohibited the exercise of due-on-sale clauses by any one of the three permitted methods prior to October 15, 1982, they were entitled to a window period until October 15, 1985, during which prohibitions against exercising the clauses would be permitted. These states, known as "window-period" states,[47] included Arizona, Arkansas, California, Florida, Iowa, Michigan, Minnesota, Nevada, New Mexico, Utah and Washington.[48]

The window period was never applicable to federal savings and loan associations because the Federal Home Loan Bank Board regulation preempted state law as to the enforceability of due-on-sale clauses and Garn-St. Germain did not establish a window period during which state restrictions against enforcement could apply to them.[49] After October 15, 1985, the window period continued only in those states which were window-period states and which extended the restrictions on enforcement of due-on-sale clauses,[50] and then only to state chartered institutions.

2. Exemptions Enumerated in Garn-St. Germain

Garn-St. Germain does not cover certain specified transfers, some of them involuntary or other transfers involving transferees likely to have difficulty raising cash to pay off the underlying obligation if the due-on clause were to be enforced.[51] In the case of real property loans secured by liens on residential real property containing fewer than five dwelling units,[52] the enumerated transfers in which due-on-sale enforcement is prohibited are:

1. The creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;
2. The creation of a purchase money security interest for household appliances;
3. A transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
4. The granting of a leasehold interest of three years or less not containing an option to purchase;[53]
5. A transfer to a relative resulting from the death of a borrower;
6. A transfer where the spouse or children of the borrower become an owner of the property;
7. A transfer resulting from a decree of dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;
8. A transfer into an *inter vivos* trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or
9. Any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board.[54]

When a transfer of one of these types is involved, the Garn-St. Germain is preemptive. Acceleration under a due-on-sale clause is prohibited even if permitted by state law.[55]

C. Federal Home Loan Bank Board Regulation

The resulting host of important and difficult interpretation problems presented by the Garn-St. Germain Act were addressed in 1983 by a final regulation issued by the Federal Home Loan Bank Board, the Preemption of State Due-on-Sale Laws.[56]

D. Postulations of Professors Nelson and Whitman

In addition to the exceptions enumerated in the Garn-St. Germain

Act, the act on its face does not preempt certain types of mortgage transfer restrictions. State law is preempted by the act with respect to due-on-sale clauses that authorize a lender, at its option, to declare due and payable sums secured by the lender's security instrument if all or any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender's prior written consent.[57] Professors Nelson and Whitman, therefore, postulate that Garn-St. Germain is inapplicable to:[58]

1. *Increased-interest-on-transfer clause.* The act is presumably inapplicable to this clause because the lender has only the right to modify or increase the interest rate upon a sale or transfer and lacks the option to declare the debt due and payable. States are, therefore, probably free to make this clause unenforceable. The result is bizarre because such clauses have an economic effect similar to that of the due-on-sale clauses, yet the practical effect of excluding these clauses is unlikely to be substantial because mortgagees may simply include due-on-sale language in any mortgage executed after the act's effective date.[59]

2. *Automatic versus optional enforcement upon transfer.* An automatic enforcement type of provision, as opposed to an optional one, seems to be outside the definition, which speaks of the lender's "option" to accelerate, and is therefore technically not covered by Garn-St. Germain. One could, therefore, draft mortgage language that would fall outside the act's definition of a due-on-sale clause.[60]

3. *Unapproved transfer a default only.* A clause that merely makes an unapproved transfer by the mortgagor a default, but says nothing about acceleration, may fall outside Garn-St. Germain. This argument is weakened, however, if the mortgage or note also contains a standard acceleration-for-default clause that the courts could read, together with the no-transfer clause, to find the equivalent of a due-on-sale clause.

These illustrations should have little practical importance, since in post-Garn mortgages, well-advised lenders will simply refrain from using such uncommon and idiosyncratic language. Only clauses in states that restrict due-on-sale enforcement potentially pose a problem. In overall economic terms, then, the act's narrow definition of a due-on-sale clause is likely to be of little importance.[61]

VI. Due-on-Encumbrance Clauses in Light of Garn-St. Germain and the Preemption[62]

A. Definition

For a due-on-encumbrance clause to be enforceable under Garn-St. Germain and the Preemption, it must first qualify as a due-on-sale clause as that term is defined in the respective act and regulation. A due-on-encumbrance clause purports to work in the same way as a due-on-sale or due-on-transfer clause and permits a lender to accelerate the loan if the borrower encumbers the property in a manner prohibited by the clause. The words "encumber" or "encumbrance" are rarely used. Rather, the prohibited action is more often defined in terms of a transfer, disposition, or conveyance—directly or indirectly, voluntarily or involuntarily, by sufferance, or by operation of law—of an interest in the real property.

It is tempting to analyze due-on-encumbrance clauses as a generic whole. Such a generalization is misleading, however, because enforcement of a given due-on-encumbrance clause depends upon the type of encumbrance and the policy reasons for prohibiting the encumbrance. Therefore, it seems more productive to view due-on-encumbrance clauses by referring to the particular type of encumbrance alleged, such as an installment land contract, junior lien, wraparound mortgage, assignment of rents and leases (separate from mortgage), easement, grant of oil and gas lease, transfer of part but not all of mortgaged premises, execution of executory contract for sale of property, transfer by one tenant in common to another, and transfer of beneficial interest in/control of borrower.

After having elected to view the particular types of encumbrances, one nevertheless concludes that nearly all of the individual types of encumbrances are validated by Garn-St. Germain. The reasons for concluding this are found in the definitions contained in Garn-St. Germain and the Preemption—in the act, if all or any part of the property, or an interest therein, securing the real property is sold or transferred without the lender's prior written approval; in the Regulation, a sale or transfer means the conveyance of real property or any right, title or interest therein (listing examples) or any other method of conveyance of real property interests.

B. Installment Land Contracts

Garn-St. Germain does not specifically address the subject of installment land contracts (land contracts, contracts for deed, installment sale contracts). The act speaks only of a loan, mortgage, advance, or credit sale secured by a lien on real property.[63] The Preemption adds to the further encumbrance exception by making it clear[64] that a transfer by installment land contract does not constitute the creation of a lien, even though courts are increasingly requiring foreclosure as a vendor's primary remedy, similar to the foreclosure of a lien[65] or other encumbrance subordinate to the lender's security instrument.[66] Prior to Garn-St. Germain, it had been held that when an individual enters into an installment land contract, while not technically triggering the "sell, convey or alienate" clause in a deed of trust, it clearly does constitute an equitable violation of that clause.[67]

If an installment land contract triggers the lender's right to accelerate under the clause, would forfeiture of the contract by the vendee's default "untrigger" that right? No, not in Iowa.[68] When the vendor-mortgagor makes arrangements for other financing, the mortgagee cannot untrigger the acceleration; his or her decision to accelerate is irrevocable once the mortgagor relies on it to his detriment. In the alternative, when the vendor-mortgagor retains payments after forfeiture and wants to use them to prepay the mortgage, he could probably do so. Similarly, a mortgagee may revoke the decision to accelerate and enforce the prepayment penalty only if the mortgagor has not relied to his detriment on the acceleration decision.[69]

C. Junior Liens

This subject of junior liens has already been referenced as one of the nine enumerated exceptions to Garn-St. Germain. However, because that exception applies only to a junior lien if real estate property *containing fewer than five dwelling units and no occupancy rights is transferred,* the act generally permits the enforcement of a due-on-encumbrance clause where any other encumbrance (e.g., commercial) junior to a first security interest lien is created.[70]

Some commentators[71] have observed that most lawyers believe that the inclusion of the residential carve out in Garn-St. Germain means the act permits enforcement of due-on-encumbrance clauses covering commercial property. They state, however, that the act is not clear. In their view, the definition of a due-on-sale clause in the Preemption only implies that the creation of a junior lien may be a transfer of a real property interest permitting enforcement of the clause. As a result, due-on-encumbrance clauses affecting commercial real estate may not be validated by Garn-St. Germain and are possibly governed by state law. If state law is to apply, then it may be to the effect that a due-on-encumbrance clause is enforceable only when it is reasonably necessary to protect the lender's security and not just to protect the lender from a rising interest market.[72]

The "less than five dwelling units" language was added to Garn-St. Germain on November 30, 1983. In its original form, the act contained no such qualification.[73] The added language modifies all of the nine exceptions listed in the act, not merely the one relating to junior liens involving no occupancy rights. In view of the broad definitions contained in both the act and the Preemption—any right, title or interest therein—it would seem that the residential qualification of the nine exceptions was not intended to cast doubt on commercial due-on clauses.

Negotiating compromises is the recommended way around a prohibition against junior liens. Many good arguments can be advanced to rebut the lender's policy reasons for advocating the prohibition.[74]

When a second mortgage is foreclosed, the mortgagee of the first mortgage may accelerate the first mortgage as a result of that mortgagor's executing a second mortgage. The exception for junior liens is not applicable because the foreclosure itself is a sale or transfer, albeit involuntary,[75] of the secured property.[76]

D. Wraparound Mortgages

A wraparound mortgage is a form of junior financing whereby the face amount of the secondary financing includes the outstanding balance of the first mortgage debt and the junior lender pays the debt service on the senior indebtedness directly to the first mortgagee, a "due-on-wrap" clause.[77] There was concern that Garn-St. Germain could be read as invalidating the due-on-encumbrance clauses. Pursuant to the act's mandate to the Federal Home Loan Bank Board, the board promulgated regulations that restricted the act's limitations on the exercise of due-on-encumbrance clauses to loans on the security of homes occupied or to be occupied by the borrower.[78]

E. Assignment of Rents and Leases (Separate from Mortgage)

Where a mortgage clause, allowing acceleration on an assignment of rents, issues, and profits without the mortgagee's consent, contained no express provision prohibiting a sale by a mortgagor, a subsequent sale of the property by the mortgagor did not violate the clause.[79]

F. Interpretations from the Law of Contracts

1. Sale of Part but Not All of the Mortgaged Premises

Garn-St. Germain literally applies to a sale of all or a part of the mortgaged property.[80] But if the mortgagor claims that the retained portion of the property is sufficient collateral for the outstanding debt, how has the mortgagee been harmed by the sale? The courts are divided. The contract permits enforcement, as is expressly permitted under the act. It is acceptable for a savings and loan association to enforce the due-on-sale clause for the purpose of improving its position in the money market.[81] However, if contract principles control, as opposed to exclusive reliance on the terms of the loan contract,[82] some courts conclude that the law of adhesion contracts, unconscionable conduct, and the duty of good faith require that the mortgagee not use the power in this instance.[83]

2. Execution of an Executory Contract for the Sale of Real Property

As a practical matter, mortgagees will not enforce the clause at the time a mortgagor executes an executory contract for the sale of real property.[84] Too many executory contracts are never closed. As a result, enforcement is not worthwhile. In addition, executory contracts are frequently not recorded, with the result that mortgagees are not made aware of their existence from a check of the public records.[85] By way of contrast, an executory contract for sale constitutes a conveyance within the terms of a prior contract which prohibited an easement or conveyance without permission of the seller. The court held that, although the term "conveyance" in a strict legal sense means a transfer of legal title to land, it also denotes any transfer of title, legal or equitable.[86]

G. Due-on-Sale Clause in an Adjustable Rate Mortgage

Such clauses should be enforced only in the context of a mortgagee showing its insecurity.[87] In the exercise of its option under the due-on-sale clause, a lender is encouraged to permit an assumption of a real property loan at the existing contract rate or at a rate that is at or below the average between the contract and market rate.[88]

H. Waiver of the Benefit of the Clause by the Mortgagee

The mortgagee may waive the benefit of the clause.[89]

I. Preemption of State Restrictions on Prepayment Fees and Yield Maintenance Fees

Garn-St. Germain did not preempt state restrictions on prepayment fees.[90] Even though a note prohibited prepayment of the loan by its terms, a lender may nevertheless permit prepayment upon the condition that the borrower pay it a yield maintenance fee to compensate or immunize the lender for the economic loss it would sustain as result of the prepayment.[91]

J. Acceleration of the Mortgage Debt and Enforcement of the Prepayment Charge When the Mortgagor Pays the Debt

In the literature, this is referred to as the "double whammy."[92] The enforcement of a due-on-sale clause along with enforcement of a prepayment penalty is a penalty, and the lender cannot enforce both. To allow that would permit the lender to obtain a double benefit from a unilateral action.[93]

The two provisions, rather than working contemporaneously, are used as economic complements to one another. While the due-on-sale clause enables a lender to require early payment of lower-than-market interest rate loans, the prepayment penalty is used to discourage refinancing by the borrower when market interest rates fall below the rate on the borrower's existing loan. The two provisions, therefore, are used by lenders to achieve different goals. Both are at least arguably necessary to protect a lender's long-term loan portfolio. While the court in *McCausland*[94] ascribes different goals to prepayment and due-on-sale clauses, they both have the same goal—minimizing the lender's interest risk when market rates rise or decrease.[95]

In some states the clauses are enforced as written.[96] Some state legislatures[97] and courts[98] allow lenders on all nonresidential loans to enforce their borrowers' waivers of this statutory protection.[99] The Federal Home Loan Bank Board, under its authority to promulgate regulations under Garn-St. Germain, prohibits prepayment penalties if a lender exercises a due-on-sale clause by written notice.[100] The board does not permit prepayment fees if the lender refuses to permit the purchaser of property to assume the mortgage.[101]

Another version of the "double whammy" is the lender's simultaneous enforcement of lock-in (prohibition against prepayment for a limited period of time) and due-on-sale clauses, which can frustrate a borrower's efforts to sell the security property. Prospective buyers cannot get the lender's approval to assume the existing loan and the seller cannot pay off the old loan because of the lock in.[102]

K. A Due-on-Sale Clause "Runs with the Land"

Individual A gives a mortgage to a bank and then sells the house to individual B who assumes or takes subject to the mortgage with the consent of the bank. B then sells the house to individual C without the bank's consent. The transfer from B to C triggers the clause, relying on the "successors and assigns" clause.[103]

L. Grant of an Easement in the Mortgaged Premises

The grant of an easement in the mortgaged premises would trigger a default under a due-on-transfer clause where a transfer is defined as the conveyance of real property or any right, title or interest therein, whether legal or equitable, whether voluntary or involuntary, by outright sale, deed, installment sale contract, land contract, contract for deed, leasehold interest with a term greater than three years, lease-option contract or any other method of conveyance of real property interests.[104]

M. Transfer of an Interest by One Tenant-in-Common to Another Tenant-in-Common

The transfer of an interest by one tenant-in-common to another tenant-in-common was held to be a transfer within the meaning of a due-on-transfer clause.[105]

N. Grant of an Option

The grant of an option by a mortgagor to an optionee who did not exercise the option was also held to be a prohibited transfer.[106]

O. Grant of Oil and Gas Lease

Although it did not determine whether the grant of an oil and gas lease would accelerate the mortgage indebtedness, the court held that granting the lease was an alienation or sale of an interest in land.[107]

VII. Transfer of Ownership Interest in or of Control of Mortgagor

A. No Express Prohibition in Due-on Clause

A transfer in substance but not in form raises all of the due-on clause questions. In this case, the owner of an entity transfers his or her ownership interest—corporate shares, general or limited partnership interest, or limited liability company membership interest—but there has been no transfer by the entity itself. Alternatively, control of the entity may be transferred.

While the specific transfer may not be a sale or transfer within the meaning of the due-on clause, from the lender's point of view, a prohibited transfer has occurred because the ownership or control of the entity has changed. The underwriting considerations of the lender likely anticipated no change in either ownership or control.

Garn-St. Germain does not address the question of a transfer of ownership or control of an entity, so the question must be decided by referring to state law. The general view is that if the legal title remains the same, even though the beneficial ownership of the entity has changed, a due-on-transfer clause will not be triggered.[108] One analogy is to a transfer of corporate ownership not triggering a prohibition against an assignment of lease by the corporation.[109]

The reasoning is the same in the case of an Illinois land trust where legal title was held by a trustee and there was a change in identity of the trust beneficiary[110] as well as in the sale and leaseback situation.[111]

B. Express Prohibition in Due-on Clauses

Each of these types of clauses—change in beneficial ownership, control, or management—of the mortgagor may, however, be expressly made the subject of a due-on clause. This was done in the commercial clauses referenced at the beginning of this article. Absent unconscionability or a finding of adhesion, there appears to be no reason why such a prohibition will not be enforced as a matter of freedom on contract. The restraint on alienation cases have not addressed this question. If they did, the prohibition would likely be found an indirect restraint on alienation, which is reasonable and, therefore, enforceable.

One must nevertheless be aware of Judge Cardozo's dissent in *Graf v. Hope Building Corporation*[112] and of the many cases that have cited that dissent. Although the majority upheld a mortgagee's right to accelerate the debt and to foreclose the mortgage following a technical payment default by the mortgagor, Judge Cardozo in his dissent argued that equity was not thereby served. No harm had been done the mortgagee as a result of the clerical or arithmetical payment error made by the mortgagor. Real harm, however, had been done the mortgagor as a result of the acceleration of debt and forfeiture of the property. The hardship was so flagrant, the misadventure so undoubted, the oppression so apparent as to justify a holding that only through an acceptance of the tender will equity be done.[113]

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tion of Mortgage Due-On-Sale Law: An Analysis of the Garn-St. Germain Act, 35 Hastings Law Journal 241 (1983); an updated and complete version of these materials appears in Grant S. Nelson and Dale A. Whitman, *Real Estate Finance Law* §§ 5.21-5.26 (3d ed. 1994).

Endnotes

1. Before Garn-St. Germain was enacted, states took two distinct approaches to due-on-sale clauses, each embodying long-standing policy preferences that had evolved in contexts outside of mortgage law. One group of states invoked the principle of freedom of alienation and put the burden on the lender to demonstrate that circumstances justified enforcement of the clause. Other states invoked the principle of freedom of contract and put the burden on the borrower to demonstrate that enforcement was not justified. States following the freedom of contract approach gave no single rationale or benchmark for requiring the borrower to demonstrate that enforcement of the due-on-sale clause was unjustified. *Mutual Federal Sav. & Loan Ass'n. v. Wisconsin Wire Works*, 71 Wis.2d 531, 239 N.W.2d 20 (1976) is a leading case endorsing due-on-sale clauses. Paul Goldstein and Gerald Korngold, *Real Estate Transactions* 444, Fns. 1 and 2 (3d ed. 1993).
2. 12 U.S.C. § 1701j-3.
3. 12 C.F.R. § 591.
4. Professors Grant S. Nelson and Dale A. Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 Hastings Law Journal 241 (1983), were among the earliest comprehensive writers on the subject. An ABA Section Committee, chaired by William B. Dunn, Esq., of Michigan, published a report in 1978, Dunn, Carpenter, Fischer, Nelson, Panzer & Shanken, *Enforcement of Due-on-Transfer Clauses*, 13 Real Prop., Prob. & Trust. J. 891 (1978), on the enforcement of due-on-transfer clauses. In addition to being a compilation of law developments to date, it recommended further analysis of some of the legal theories and offered suggestions for better results. As a pioneering work, it was cited by a number of courts in the country and directly influenced the decisions of several state supreme courts in finding such clauses enforceable as matters of first impression. That work was followed by an article appearing in the ABA Journal in 1981, Dunn & Nowinski, *Enforcement of Due-On-Transfer Clauses: An Update*, 16 Real Prop., Prob. & Trust J. 291 (1981), dealing with the impact of federal preemption.
5. 12 U.S.C. § 1701j-3(a)(1).
6. 12 C.F.R. § 591.2(b).
7. Grant S. Nelson and Dale A. Whitman, *Real Estate Finance Law* 333 (3d. ed. 1994).
8. Federal National Mortgage Association/ Federal Home Loan Mortgage Corporation Mortgage, clause 17 (one- to four-family homes), cited in Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* (4th ed. 1992) 457, note 1.
9. Another lender defines a lien as any mortgage, deed of trust, lien (statutory or other), pledge, hypothecation, assignment, preference, priority, security interest, or any other encumbrance or charge on or affecting any collateral or any portion thereof, or any interest therein (including, without limitation, any conditional sale or other title retention agreement, any sale-leaseback, any financing lease having substantially the same economic effect as any of the foregoing, the filing of any financing statement or similar instrument under the Uniform Commercial Code or comparable law of any other jurisdiction, domestic or foreign, and mechanic's, materialmen's, and other similar liens and encumbrances.
10. Still another lender defines "transfer" with respect to any property, as the pledge, sale or other whole or partial conveyance of such property or any direct or indirect interest therein to a third party, other than through a lease.
11. A different lender defines "change of control of borrower" as (A) the sale or direct or indirect transfer by borrower or persons that are affiliates of borrower (whether accomplished in one transaction or a series of transactions) to persons not directly or indirectly wholly owned by borrower, of (i) a majority of the aggregate right to distributions from borrower, (ii) any interest in the general partner, or (iii) any interest of the general partner in borrower; or (B) any other transaction or series of transactions as a result of which (i) borrower shall cease directly or indirectly to control borrower, or (ii) borrower shall cease to hold, directly or indirectly, a majority of the aggregate right to distributions from borrower. The sale or direct or indirect transfers of ownership interest in "borrower" (or in any person that is a partner of borrower) shall not constitute a "change of control of borrower."
12. Nelson and Whitman, *Real Estate Finance Law* 333 (3d ed. 1994), citing cases.
13. Banks in the late 1960s and early 1970s were faced with "borrowing short and lending long," borrowing with short-term notes and paying off the short-term notes with income from their long-term mortgage portfolios. Because of rising interest rates in the capital markets, banks received low rates of interest from their mortgage portfolios and paid higher rates of interest as borrowers in the capital market for their residential and other types of mortgagors. George Lefcoe, *Real Estate Transactions* 439-440 (1993). As a consequence of the resulting capital shortage, banks needed to turn over their loans at a faster pace in order to keep up with the short-term capital markets in which they found themselves. D. Barlow Burke, Jr., *Real Estate Transactions* 256 (1993).
14. Paul Goldstein and Gerald Korngold, *Real Estate Transactions* 432 (3d ed.1993). The due-on-sale clause is a mortgage provision that affords the mortgagee the right to accelerate the mortgage debt and to foreclose if the mortgaged real estate is transferred without the mortgagee's consent. While the clause is sometimes used to protect mortgagees against transfers that endanger mortgage security or increase the risk of default, its major purpose is to enable mortgagees to recall lower-than-market-interest-rate loans during periods of rising interest rates. *See Malouff v. Midland Federal Sav. & Loan Ass'n*, 181 Colo. 294, 509 P.2d 1240 (1973).
15. A due-on-encumbrance provision prohibits any financing by the borrower, in addition to the loan, without the prior written consent of the lender; financing is secured either by a mortgage lien or other encumbrance on the improvements or property (or any part thereof). Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 456 (1991).
16. Grant S. Nelson and Dale A. Whitman, *Land Transactions and Finance* 207 (2d ed. 1985); Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 461-462 (1991), listing six reasons why lenders prohibit junior financing; a due-on-encumbrance clause is much less frequently used than its due-on-sale counterpart. Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* 458 (4th ed. 1992).
17. Where a mortgage clause allowing acceleration on an assignment of rents, issue, and profits without the mortgagee's consent contained no express provision prohibiting a sale by the mortgagor, a subsequent sale of the property by the mortgagor did not violate the clause. *Woodcrest Apartments, Ltd. v.*

IPA Realty Partners Richardson Palmer, etc. 397 So.2d (Fl. App. D1 1981).

18. Before Garn-St. Germain was enacted, states took two distinct approaches to due-on-sale clauses, each embodying long-standing policy preferences that had evolved in contexts outside mortgage law. One group of states invoked the principle of freedom of alienation and put the burden on the lender to demonstrate that circumstances justified enforcement of the clause. Other states invoked the principle of freedom of contract and put the burden on the borrower to demonstrate that enforcement was not justified. For a pre-Garn survey of the different approaches, see *A.B.A. Comm. on Real Estate Financing, Enforcement of Due-on-Transfer* Clauses, 13 Real Prop., Prob. & Trust J. 891 (1978), cited in Paul Goldstein and Gerald Korngold, *Real Estate Transactions* 444 (3d ed. 1993).

19. Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 465 (1991).

20. *E.g., Beacon Fed. Sav. & Loan Assn. v. Marks*, 91 A.D.2d 1010, 457 N.Y.S.2d 881 (2d Dep't 1983); *Ceravolo v. Buckner*, 111 Misc. 2d 676, 444 N.Y.S.2d 861 (Sup. Ct., Ontario Co. 1981) (transfer of equitable title by a land contract was a transfer sufficient to trigger a due-on-sale clause, concluding that each case must be decided on its own particular facts and, most importantly, upon the specific contractual language); *First Fed. Sav. & Loan Assn. v. Jenkins*, 109 Misc. 2d 715, 441 N.Y.S.2d 373 (Sup. Co., Tompkins Co. 1981); *Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank*, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (Sup. Ct., N.Y. Co. 1977); *Stith v. Hudson City Sav. Institution*, 63 Misc. 2d 863, 313 N.Y.S.2d 804 (Sup. Ct., Broome Co. 1970) (the first recorded New York case addressing the enforceability of a due-on-sale clause).

21. Curtis J. Berger and Quintin Johnstone, *Land Transfer and Finance* 182-183 (4th ed. 1993).

22. *Id.*

23. No court has held that a due-on-sale clause is per se unlawful as a restraint on alienation. Some courts have held that it is not a restraint at all. Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Estate, and Development* 460 (4th ed. 1992).

24. An increase in the market interest rate is not usually thought sufficient to meet this burden. Some courts have cautioned that the borrower must be adequately warned of the consequences of the clause. *Id.* at 460.

25. *Id.* at 460-461 (4th ed. 1992).

26. 12 U.S.C. § 1701j-3(d).

27. Thus, a mortgage that provides for forfeiture of the mortgaged real estate to the mortgagee upon an impermissible transfer probably constitutes a direct restraint. To the extent that the mortgagee is able to enforce, through specific performance or injunctive relief, a mortgagor's promise not to convey without the mortgagee's consent, a promissory and presumably direct restraint exists. Under this analysis it is unclear whether the due-on-sale clause constitutes a direct or an indirect restraint on alienation. On the one hand, it can be argued that it constitutes an indirect restraint in that enforcement of the clause will result in a foreclosure sale rather than a forfeiture of the mortgaged real estate to the mortgagee, and the due-on-sale mortgagee does not have an enforceable right to prevent the mortgagor from transferring the property. Moreover, the practical effect of the clause may be to discourage the mortgagor from selling the mortgaged real estate. Its primary purpose is to confer an economic benefit, not to restrain alienability. Grant S. Nelson and Dale A. Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 Hastings L.J. 241, 251 (1983).

28. George Lefcoe, *Real Estate Transactions* 439 (1993); a due-on-sale clause is not a restraint on alienation since it permits an owner to transfer property subject to acceleration of debt by the creditor. Although this may impede transfer, other impediments to transfer such as zoning or building restrictions are also not considered either a restraint on alienation or contrary to public policy. *Metropolitan Life Ins. Co. v. Strand*, 255 Kan. 657, 876 P.2d 1362 (1994).

29. *Security First Federal Savings & Loan Assn. v. Jarchin*, 479 So.2d 767 (Fla. App. 1985) (clause prohibited conveyance if made without mortgagee consent *and* without assumption by grantee; the mortgagee was not permitted to accelerate where good faith attempt to assume was frustrated by mortgagee, involving a pre-Garn-St. Germain transfer). Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* 471 (4th ed. 1992).

30. *La Sala v. American Sav. & Loan Ass'n*, 5 Ca.3d 861, 489 P.2d 1113 (1971) (affirming the rule that California Civil Code section 711, voiding conditions restraining alienation when repugnant to the interest created, prohibits only unreasonable restraints on alienation).

31. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 460 (4th ed. 1992) (citing *Wellenkamp v. Bank of America*, 148 Cal. Rptr. 379 (Ca. 1978)); *Tucker v. Pulaski Federal Savings & Loan Assn*, 481 S.W.2d 725 (Ark. 1972); the *Wellenkamp* rule applies to noninstitutional lenders and to commercial property; *Dawn Investment Co., Inc. v. Edith Beck et al.*, 30 Cal.3d 695, 639 P.2d 974 (1982).

32. Nelson and Whitman, *Real Estate Finance Law* 332 (3d ed. 1994).

33. Ariz. Rev. Stat. § 33-806; Colo. Rev. Stat. § 38-30-165; Iowa Code § 535.8; N.M. Stat. § 48-7-15 to 48-7-24; Minn. Stat. § 47.20; Utah Code § 57-15-1 to 57-15-10.

34. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 461 (4th ed. 1992).

35. 41 Fed. Reg. 18,286-287 (1976); 12 C.F.R. § 545.6-11(f); Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 462 (4th ed. 1992).

36. 458 U.S. 141 (1982).

37. Berger and Johnstone, *Cases and Materials on Land Transfer and Finance* 182-183 (4th ed. 1993); *de la Cuesta* did not address the enforceability of due-on-sale clauses included in mortgage loans made by federal associations before the effective date of the 1976 Board Regulation. *See* Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 462 (4th ed. 462).

38. 12 U.S.C. § 1701j-3.

39. Preemption of State Due-on-Sale Laws, Federal Home Loan Bank Board, 12 C.F.R. § 591.

40. Any person or government agency making a real property loan. 12 U.S.C. 1701j-3(a)(2). The act does not say that it does not apply so it does apply. *Western Life Ins. Co. v. McPherson K.M.P.*, 702 F. Supp. 836 (D. Kan. 1988); *Eyde Bros Dev. v. Equitable Life Assurance Society. of the United States*, 697 F. Supp. 1431 (W.D. Mich.), *aff'd without op.*, 888 F.2d 127 (1988); *McCausland v. Bankers Life Ins. Co. of Nebraska*, 110 Wash. 2d 716, 757 P.2d 941 (1988). Burke D. Barlow, Jr., *Real Estate Transactions* 262 (1993). Because the list of affected lenders was intended to be representative and not exclusive, every mortgagee, whether a natural person, business entity, or government agency, is covered by the act. Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* 466-467 (4th ed. 1992).

41. Garn-St. Germain gave states the option of applying their own rules to due-on-sale clauses appearing in the mortgages of state-chartered and state-regulated lending institutions. Pursuant to New York Banking Law § 6-g, New York elected to make federal preemption inapplicable to residential real property and cooperative apartment unit alternative

mortgage transactions and to make them subject to the laws of the state. Maine, Massachusetts, South Carolina, and Wisconsin also exercised their option. In these states, due-on-sale clauses remain enforceable if they are written by a federally chartered lender, but they might not be enforceable if the loan is written by a state-chartered lender. George Lefcoe, *Real Estate Transactions* 441 (1993).

42. Every loan, mortgage, advance, or credit sale secured by a lien on real property, the stock allocated to a dwelling unit in a cooperative housing corporation, or a residential manufactured home, whether real or personal property. 12 U.S.C. § 1701j-3(a)(3). While Garn-St. Germain is silent, the Preemption at 12 C.F.R. § 591.2(g) provides that a loan is secured by a lien on real property if it is made on the "security of any instrument . . . which makes . . . a leasehold or subleasehold . . . specific security for payment of the obligation secured by the instrument." Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 467 (4th ed. 1992).

43. D. Barlow Burke, Jr., *Real Estate Transactions* 257-258 (1993).

44. Curtis J. Berger and Quintin Johnstone, *Land Transfer and Finance* 183 (1993).

45. 12 U.S.C. § 1701j-3(c).

46. 12 U.S.C. § 1701j-3(c)(1).

47. Illinois was held not to be a window-period state. *North Community Bank v. Northwest Nat. Bank*, 126 Ill. App.3d 581, 467 N.E.2d 1094 (1984) Restrictions on enforcement of due-on-sale clauses when a lender acts unconscionably or inequitably are not sufficient to qualify Illinois as a window-period state under the Garn-St. Germain Act. New York had no constitutional, statutory provision or judicial decision in place at the time Garn-St. Germain was enacted, thus the window period provisions have no application here. *Home Sav. Bank v. Baer Properties, Ltd.*, 92 A.D.2d 98, 460 N.Y.S.2d 833 (3d Dep't 1983).

48. John P. Ludington, *Validity and Enforceability of Due-on-Sale Real-Estate Mortgage Provisions*, 61 A.L.R.4th 1070 (1997); Curtis J. Berger and Quintin Johnstone, *Land Transfer and Finance* 183 (4th ed. 1993).

49. "A federal association continues to have the power to include . . . a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent." 12 C.F.R. § 545.8-3(f); upheld in *U.S. Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141 (1982).

50. Arizona, Michigan, Minnesota, New Mexico and Utah extended the cutoff date beyond 1985. However, the window period concept has very little continuing importance, both because of the small number of states that extended the 1985 cutoff date and because even in those states there are relatively few window period loans left "on the books" today. Moreover, the window period concept is inapplicable to loans by federally chartered savings associations, federal credit unions, or national banks. Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* 472 (4th ed. 1992). The reference in § 1701j-3(c)(1) to "subsection" should be read to mean all of subsection (c) with the result that subsection (c) creating the window period does not apply to a federal savings and loan association or federal savings bank. *First Federal Sav. & Loan Ass'n*, 285 Ark. 372, 688 S.W.2d 269 (1985).

51. Curtis J. Berger and Quintin Johnstone, *Land Transfer and Finance* 183 (1993).

52. This "less than five dwelling units" language was added to Garn-St. Germain on November 30, 1983. In its original form, the act contained no such qualification. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 469 (4th ed. 1992).

53. The granting of a lease with an absolute option to buy the premises after a fixed period and crediting of rental payment to the eventual purchase price did trigger a due on sale clause. *Auernheimer v. Metzen*, 98 Or. App. 722, 780 P.2d 796, *rev. den.*, 308 Or. 660, 784 P.2d 1101 (1989).

54. 12 U.S.C. § 1701j-3(d) (the enumerated transfers in which due-on-sale enforcement is prohibited are similar to but not identical to the analogous provisions of the FNMA/FHLMC mortgage form and the 1976 FHLBB Regulation. Nelson and Whitman, *Real Estate Finance Law* 469 (4th ed. 1992)).

55. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 469 (4th ed. 1992).

56. 12 C.F.R. § 591 (1983); this result is consistent with the great majority of pre-Garn state decisions. Nelson and Whitman, *Land Transactions and Finance* 212 (2d ed. 1985).

57. 12 U.S.C. § 3(a)(1); the Preemption adopts this statutory definition virtually unchanged. Words like "sale" and "transfer" are defined by state case law, Nelson and Whitman, *Real Estate Transfer, Finance and Development* 467 (4th ed. 1992).

58. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 467-468 (4th ed. 1992).

59. Where a due-on-sale clause provides that the mortgagee may accelerate upon any sale or transfer but shall not unreasonably withhold consent to the sale or transfer, the mortgagee may be able to raise the interest rate as a precondition to giving its consent. It can be argued that the mortgagee may evaluate the creditworthiness of the borrower in order to determine whether the transferee is of equal or better creditworthiness. In the comparable area of a lease assignment case, this is the accepted interpretation of such language. *But see Western Life Ins. Co. v. McPherson K.M.P.*, 702 F. Supp. 836 (D. Kan. 1988) (holding otherwise when the credit of the transferee was not an issue). D. Barlow Burke, Jr., *Real Estate Transactions* 261 (1993).

60. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* (4th ed. 1992).

61. *Id.* at 467-468.

62. Some of these examples and explanations are suggested by D. Barlow Burke, Jr., *Real Estate Transactions* 255-263 (1993).

63. 12 C.F.R. § 491.2(h). An installment land contract differs from a due-on-sale clause where an unapproved transfer will trigger acceleration of the mortgage debt, because violation of a provision which prohibits assignment by the vendee without the vendor's permission constitutes a default and might result in vendor termination of the contract and loss of the purchaser's equity. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 459 (4th ed. 1992). A prohibition on transfer that purports to go beyond simple acceleration and defines the remedies (such as forfeiture) to be imposed on the vendee is unaffected by Garn-St. Germain and is thus still subject to pre-Garn state law. It is highly unlikely that a state court would enforce forfeiture, with its harsh consequences, simply because a transfer was made without the vendor's consent. A more likely judicial response would be to permit foreclosure of the contract as a mortgage. Such an approach would not be inconsistent with the policy inherent in the act. *Id.* at 469.

64. Where is the authority for that in the statute? D. Barlow Burke, Jr., *Real Estate Transactions* 260 (1993).

65. Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 468 (4th ed. 1992).

66. 12 C.F.R. § 591.5(1)(i). The question presented is whether, in an installment contract, the vendor retains a lien on real

property. The Preemption answers the question by using the phrase "land contract," so it is "probably correct." Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 468 (4th ed. 1992). This addition is probably unnecessary because an installment land contract transfer almost always entails the transfer of occupancy rights while, in order for the exception to apply, Garn-St. Germain states that the creation of the lien or encumbrance must "not relate to a transfer of rights of occupancy in the property." 12 U.S.C. § 1701-j-3(d)(1). The bank board's interpretation of the exception is correct: The act's "further encumbrance" exception is aimed at protecting mortgagors who have no intent to sell or transfer ownership but want to create non-purchase money junior liens on their real estate for a variety of business or personal reasons. *Id.* at 470; *Ceravolo v. Buckner*, 111 Misc. 2d 676, 444 N.Y.S.2d 861 (Sup. Ct., Ontario Co. 1981) (transfer of equitable title by a land contract was a transfer sufficient to trigger a due-on-sale clause). Because the installment sale land contract triggers the due-on-sale covenant, the court is preempted by the act from considering the covenant's validity as an unreasonable restraint on alienation. Burke, *Real Estate Transactions* 259 (1993).

67. *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal.3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) (the court did not enforce the clause, however, because the lender failed to show how the land contract impinged on its legitimate interests so as to justify enforcement); *Rustic Hills Shopping Plaza, Inc. v. Columbia Sav. & Loan Ass'n*, 661 P.2d 254 (Colo. 1983); *Krause v. Columbia Sav. & Loan Ass'n* 631 P.2d 1158 (Colo. App. 1981); *Bakker v. Empire Sav. Bldg. & Loan Ass'n*, 634 P.2d 1021 (Colo. App. 1981), *app. dism'd,* 653 P.2d 385 (1981); *Society for Sav. v. Bragg*, 38 Conn. Sup. 8, 444 A.2d 919 (1981) (following the title theory of mortgages under which, on execution of the mortgage deed, legal title vests in the mortgagee); *First Federal Sav. & Loan Ass'n v. Peery's Landing, Inc.*, 11 Ohio App.3d 135, 463 N.E.2d 636 (1983); *First Federal Sav. & Loan Ass'n v. Fox*, 440 So.2d 652 (Fla. App.2d 1983); *Jenkins v. Malone*, 695 S.W.2d 186 (Tenn. 1985); *contra*, *Peoples Federal Sav. & Loan Ass'n v. Willsey*, 466 N.E.2d 470 (Ind. App. 1984); *Darr v. First Federal Sav. & Loan Ass'n*, 426 Mich. 11, 393 N.W.2d 152 (1986) (a land contract is a conveyance); *Mutual Federal Sav. & Loan Ass'n v. Wisconsin Wire Works*, 58 Wis.2d 99, 205 N.W.2d 762 (1973).

68. *Home Fed. Sav. & Loan Ass'n v. Campney*, 357 N.W.2d 613 (Iowa 1984).

69. *In re Adu-Kofi*, 94 B.R. 14 (Bankr. R.I. 1988), D. Barlow Burke, Jr., *Real Estate Transactions* 260-261 (1993).

70. 12 U.S.C. § 1701j-3(d)(1); Garn-St. Germain effectively overturned judicial decisions prior to 1982 denying enforcement of due-on-encumbrance clause in the non-residential context. Robert A. Thompson and Brian D. Smith, *Negotiating Loan Transactions*, 325 PLI/Real 131 § 3.27 (1989).

71. Alan Wayte, *Real Estate Financing Documentation: Coping With the New Realities*, ALI-ABA Course of Study Materials 37 (1997); James L. Lipscomb, *Yielding to Yield Mainten-ance: A Borrower's or Lender's Dilemma?*, C474 ALI-ABA 1 (1990).

72. *LaSala v. American Sav. & Loan Ass'n*, 5 Cal.3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); *Egbert v. Freedom Federal Savings and Loan Ass'n*, 14 Mass. App. Ct. 383 (finding that where there is fair bargaining by experienced business people, a due-on-encumbrance agreement will be enforced).

73. Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development* 469 (4th ed. 1992).

74. Thompson and Smith, *Negotiating Loan Transactions*, 325 PLI/Real 131 § 3.27 (1989).

75. *Planters' Lumber Co. v. Griffin Chapel M.E. Church*, 157 Miss. 719, 128 So. 76 (1930) (clause stating that, should the corporate existence of the church cease or its church property be alienated, money advanced would become due and payable applied only to a voluntary alienation, not to a $2,000 advance to the board of home missions considered a gift).

76. *Unifirst Fed. Sav. & Loan Ass'n v. Tower Loan of Mississippi*, 524 So. 2d 290 (Miss. 1986); D. Barlow Burke, Jr., *Real Estate Transactions* 261 (1993); *but see*, *Yelen v. Bankers Trust Co.*, 476 So.2d 76 (Fla. App. 1985) (lender, by expressly permitting borrower to execute subordinate mortgage, implicitly waived acceleration option in event of subordinate lienholder's foreclosure of its mortgage); *Egbert v. Freedom Federal Sav. & Loan Ass'n*, 14 Mass. App. 383, 440 N.E.2d 22 (1982) (second mortgage was within scope of acceleration clause); *In re Ruepp*, 71 N.C. App. 146, 321 S.E.2d 517 (1984).

77. Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 457 (1991).

78. 12 C.F.R. § 91.5; Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 462 (1991); *Phillips v. Superior Court of County of Pima*, 143 Ariz. 189, 692 P.2d 1038 (1984).

79. *Woodcrest Apartments, Ltd. v. IPA Realty Partners Richardson Palmer*, 397 So.2d (Fl. App. D1 1981).

80. 12 U.S.C. § 1701j-3(a)(1).

81. *Frets v. Capital Fed. Sav. & Loan Ass'n*, 238 Kan. 614, 712 P.2d 1270 (1986).

82. 12 U.S.C. § 1701j-3(b)(2).

83. Burke, *Real Estate Transactions* 259-260 (1993).

84. *First Federal Sav. & Loan Ass'n v. Botello*, 725 F.2d 350 (5th Cir. 1984).

85. Burke, *Real Estate Transactions* 260 (1993); Roszowski, *Drafting Around Mortgage Due-on-Sale Clauses: The Dangers of Playing Hide and Seek*, 21 Real Prop., Prob. & Trust J. 23 (1986); *Fidelity Federal Savings and Loan Ass'n v. Grieme*, 112 Ill. App.3d 1014, 68 Ill. Dec. 558, 446 N.E.2d 292 (1983) (entering into an agreement for a deed held insufficient to trigger a clause allowing lender to accelerate upon a change in ownership); *contra*, *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190, *pet. den.* 108 Ariz. 192, 494 P.2d 1922 (1971).

86. *Terry v. Born*, 24 Wash. App. 652, 604 P.2d 504 (1979).

87. Murrey, *Due-on-Sale Clauses in Adjustable Rate Mortgages*, 12 Real Est. L.J. 229 (1983).

88. 12 U.S.C. § 1701j-3(b)(3).

89. *Cooper v. Deseret Fed. Sav. & Loan Ass'n*, 757 P.2d 483 (Utah App. 1988) (in which the mortgagee has knowledge of the sale or transfer for a four-year period, during which the mortgagor foreclosed a purchaser's interest and tendered mortgage payments to bring the loan in balance). Burke, *Real Estate Transactions* 261 (1993).

90. *Warrington 611 Associates v. Aetna Life Insurance Co.*, 705 F.Supp. 229 (U.S. Dist. 1989), citing *McCausland v. Bankers Life Insurance Co.*, 110 Wash.2d 716, 757 P.2d 941 (1988) (the prohibition merely prevented the borrower from refinancing the property; it did not prevent him or her from selling and is not to be viewed as a restraint on alienation).

91. *Warrington 611 Associates v. Aetna Life Insurance Co.*, 705 F.Supp. 229 (U.S. Dist. 1989). This distinction is made very well in James L. Lipscomb, *Yielding To Yield Maintenance: A Borrower's Or Lender's Dilemma?*, C474 ALI-ABA 1 (1990).

92. Michael T. Madison and Robert M. Zinman, *Modern Real Estate Financing* 469 (1991).

93. *In re LHD Realty Corp.*, 726 F.2d 327 (7th Cir. 1984) (holding that a mortgagee cannot accelerate the outstanding debt

and concurrently levy a prepayment charge). *See* Stark, *Enforcing Prepayment Charges: Case Law and Drafting Suggestions*, 22 Real Prop., Prob. & Tr. J. 549, 554-555 (1987). *LHD Realty Corp.; Slevin Container Corp. v. Provident Federal Savings & Loan Assn.*, 98 Ill. App.3d 646, 424 N.E.2d 939 (1981); *McCausland v. Bankers Life Insurance Co.*, 110 Wash.2d 716, 757 P.2d 941 (Wash. 1988); *America Federal Savings & Loan Assn. v. Mid-America Service Corp.*, 329 N.W.2d 124 (S.D. 1983).

94. *McCausland v. Bankers Life Insurance Co.*, 110 Wash.2d 716, 757 P.2d 941 (Wash. 1988).

95. George Lefcoe, *Real Estate Transactions* 145 (1993).

96. *Pacific Trust Co. TTEE v. Fidelity Fed. Sav. & Loan Ass'n*, 184 Cal. App.3d 817, 229 Cal. Rptr. 269 (1986).

97. Cal. Civ. Code § 2954.10 (but waivers after January 1, 1984 must be separately signed or initialed by the obligor and their enforcement supported by evidence of a course of conduct by the obligee of individual weight to the consideration in that transaction for the waiver or agreement); N.Y. Real Prop. Law § 254-a; Va. Code Ann. § 6.1-330.33 (no prepayment penalty when lender accelerates under due-on-sale clause).

98. *Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n*, 424 N.E.2d 939 (Ill. 1981); *Crockett v. First Fed. Sav. & Loan Ass'n*, 224 S.E.2d 580 (N.C. 1976) (prohibit penalties when the prepayment results from lenders accelerating debts under a due-on-sale clause on owner-occupied properties).

99. George Lefcoe, *Real Estate Transactions* 446 (1993).

100. 12 C.F.R. § 591.6(b)(2).

101. 12 C.F.R. § 591.5(b)(2); Lefcoe, *Real Estate Transactions* 446 (1993).

102. Lefcoe, *Real Estate Transactions* 447 (1993); *Trident Ctr. Connecticut Gen. Life Ins. Co.*, 847 F.2d 564 (9th Cir. 1988); *Eyde Bros. Dev. Co. v. Equitable Life Assurance Soc. of the United States*, 697 F. Supp. 1431 (W.D.Mich 1988), *aff'd without opinion*, 888 F.2d 127 (Mich. 1989) (leaving the commercial borrower no way to release itself from the loan agreements in which it had tied up itself).

103. *Esplendido Apartments v. Metropolitan Condominium Ass'n*, 161 Ariz. 325, 778 P.2d 1221 (1989); Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 472 (4th ed. 1992).

104. 12 C.F.R. § 591.2(b).

105. *Davis v. Vecaro Development Corp.*, 101 N.C. App. 554, 400 S.E.2d 83 (1991) (a debatable transfer); Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 471 (4th ed. 1992); *Phillips v. Superior Court of County of Pima*, 143 Ariz. 189, 692 P.2d 1038 (1984) (transfer from one co-owner to another of residence located on lot in excess of 212 acres, nor subsequent transfer of residence to third parties in which seller took back a wrap-around mortgage justified acceleration of underlying mortgage absent showing of impairment of security).

106. *Auernheimer v. Metzen*, 98 Or. App. 722, 780 P.2d 796 (1989) (can this be correct? Is an option an interest in land?); Nelson and Whitman, *Real Estate Transfer, Finance, and Development* 471 (4th ed. 1992); parties' entry into an agreement to exchange residences under "Metro Option Loan Plan," pursuant to which each party received an option to purchase that could be exercised within agreed period of time, with deed to property held in escrow until buyer's entire consideration was paid, triggered due-on-sale clause where—for all practical purposes—parties acted like sellers and buyers of property, in that "if something walks like a duck, acts like a duck and quacks like a duck, it's a duck!" *Greater Louisville First Federal Sav. & Loan Ass'n v. Etzler*, 659 S.W.2d (Ky. App. 1983).

107. *Federal Land Bank. v. Mulhern*, 180 La. 627, 157 So. 370 (1934).

108. *Fidelity Trust Co. v. BVD Associates*, 196 Conn. 270, 492 A.2d 180 (1985) (the general partner remained the same and the limited partnership was viewed as a separate entity); *Home Savings Bank of Upstate New York v. Baer Properties*, 92 A.D.2d 98, 460 N.Y.S.2d 833 (3rd Dept. 1983); *Hodge v. DMNS Co.*, 652 S.W.2d 762 (Tenn. App. 1982) (due-on-sale clause not activated when partnership-debtor underwent fundamental change by withdrawal of two of four partners, nor was clause activated when partnership entered into contract to sell the property to two remaining partners where parties rescinded the agreement); *Fidelity Federal Sav. & Loan Ass'n v. Grieme*, 112 Ill. App.3d 1014, 446 N.E.2d 292 (1983); *Phillips v. Superior Court of County of Pima*, 143 Ariz. 189, 692 P.2d 1038 (1984) (title in name of limited partnership where partnership admitted new limited and general partners).

109. *Gasparre v. 88-36 Elmhurst Ave. Realty Corp.*, 119 Misc. 2d 628, 464 N.Y.S.2d 106 (Queens Co. 1983).

110. *Mercado v. Calumet Fed. Sav. & Loan Ass'n*, 196 Ill. App.3d 483, 143 Ill. Dec. 370, N.E.2d 305 (1990) (which summarizes the cases); *Fairbury Fed. Sav. & Loan Ass'n v. Bank of Illinois*, 122 Ill. App.3d 808, 462 N.E.2d 6 (1984) (there has been no transfer by the entity); *Oak Trust & Sav. Bank v. Chicago Title & Trust Co.*, 129 Ill App.3d 250, 472 N.E.2d 497 (3d Dist. 1984); *Barnes v. VNB Mortgage Corp.*, 230 Va. 4, 334 S.E.2d 531 (1985); *contra*, *Damen Sav. & Loan Ass'n v. Heritage Standard Bank & Trust Co.*, 103 Ill App.3d 301, 431 N.E.2d 34 (1982) (conveyance from the individual mortgagor to a trustee of record title under a standard Illinois land trust); *Williams v. First Federal Sav. & Loan Ass'n*, 651 F2d 910 (1981) (applying Virginia law to the creation of a land trust and the subsequent assignment of the beneficial interest in the land trust), *distinguished at Wachta v. First Federal Sav. & Loan Ass'n*, 103 Ill. App.3d 174, 430 N.E.2d 708 (1981); *Williams v. First Federal Sav. & Loan Ass'n*, 651 F.2d 910 (4th 1981) (conveyance by a vendor of residential real estate to herself as trustee under a land trust, in combination with the assignment of her beneficial interest in the land trust to the purchasers of the property, violated a due-on-sale clause).

111. *First Fed. Sav. & Loan Ass'n v. Treaster*, 490 N.E.2d 1149 (Ind. App. 1986).

112. 254 N.Y. 1, 171 N.E. 884 (1930).

113. 254 N.Y. 1, 13, 171 N.E. 884, 888 (1930).

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Hotel Investment and Lending: Issues on the Downward Curve

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The stock market declines of mid-year 1998 struck hotel stocks with particular violence. Hotel real estate investment trusts (REITs) recorded a year-to-date stock price decline of 40 percent at the end of August 1998.[1] Of the top 80 lodging and hotel stocks tracked by one information service, more than half recorded price declines of 30 percent or more for the same period.[2] In contrast to the declines in the broader market indices, hotel stocks gave up much more than the gains accumulated in the last year. The price declines took many hotel stocks back to levels of two and three years ago and represented historic lows for some companies. In parallel with this decline of value for hotels owned by corporations or REITs, individual hotel valuations are perceived to be in a downward trend. Valuations and feasibility studies are becoming more conservative. Hotels offered for sale now seem to take longer in the market and to receive fewer bids. The rate of acquisition of individual properties appears to have fallen off. In general, the hotel market is described as having "backed off" its euphoria of the last few years.

The consequences of these changes are beginning to be felt in difficulty raising new equity for hotel deals in the public markets, increasingly conservative hotel valuations, restricted access to financing for new development and refinancing, and more difficulty in selling hotel portfolios. Lawyers dealing with the hotel industry may soon face new challenges in their work. Some of the them will be recurring issues of failed investment familiar to those who dealt with the hotel industry in the early 1990s. Other novel issues will emerge from the recent, much more complex interaction of the hotel industry with the public securities markets and innovative financing structures. These were not widely relevant to the industry in the last economic downturn. This article focuses on the changes facing the hotel industry and the legal concerns arising from them.

Information Sources

Key to understanding these new issues is the fact that investors and lenders now deal with the hotel industry with more and better information about the industry than was available to them at the beginning of the last downturn. Databases on the industry are maintained by a variety of affiliated and independent sources. These have facilitated the willingness of investors to look at the lodging industry as a specific asset category that can be understood and funded by the public markets. The consequent growth of a public market for hotel debt and equity has provided additional disclosure, giving analysts expanded insight into how hotels operate. Particularly important in triggering this expansion of investment have been efforts to compile comparative information on provisions in management agreements[3] and on results of operation on a per-room basis by market and type of hotel.[4]

There have also been extensive efforts to "segment" the industry into analytic units, grouped by such classifications as "luxury," "midprice," "extended stay" and "limited service."[5] Regional segments have also been identified and tracked. Recently, several investment banks and accounting firms have begun publishing periodic analyses of the industry using proprietary software models, in which information from other data sources is combined with more general information on construction starts and economic indicators.[6] Thus, investors and lenders who might previously have engaged in prolonged negotiations and speculation about value and performance trends may be quickly confronted with red flags thrown up from a variety of independent and relatively reliable sources. There is little question that the speed and breadth of the recent downturn of hotel stocks have direct links to the availability of information, some of which is correct and some speculative. News of over-capacity and declining occupancies has moved throughout the industry in a manner unimaginable ten years ago, with obvious effect.

The growth of information available to investors and lenders has also generated a new vocabulary. In addition to the new "segment" categories, documentation for hotel deals now refers to average daily rate (ADR), occupancy (percentage of available rooms occupied in a given period), and revenue per available room (RevPAR). For example, performance tests—which increasingly are triggers for terminating operators or increasing obligations of borrowers in hotel transactions—may refer to a hotel's performance on RevPAR in comparison with its "competitive set."[7] An owner may use the concept of a competitive set in documentation to require an equivalent level of performance; an operator may counter by seeking to be excused from weak results if it does no worse than its competitive set. The sophistication of the terminology and the underlying concepts places a burden on the lender, investor or legal counsel who only occasionally engages in hotel transactions. More generally, the scope of the information available and the use of public markets to raise debt and equity for hotels pose complex legal questions of how to satisfy legal requirements for factual disclosure of business issues and investment risk factors. A general reference to hotels as being subject to general economic trends may not be legally adequate, where analysis may now be provided by individual hotel, region and market segments.

The Recent Market

As recently as a year ago, the overall hotel market was reported to be strong, with record prices being paid for existing hotels. Several factors contributed to this. Hotel REITs attracted capital at low cost and were motivated to grow by acquisition to maximize their growth in funds derived from operations. Hotel companies, fresh from their initial public offerings, had substantial new credit lines and business plans that required rapid growth. Mergers of public companies created still larger companies that could raise capital even more cheaply and were carried on the wave of an ebullient stock market. The supply of new hotel rooms had been suspended in the early 1990s, and the rate of increase in demand by travelers exceeded the growth of the supply of new rooms for several years after the economy revived. This drove up all occupancy, ADR and RevPAR, the last category regarded by buyers as a key indicator of the comparative value of hotels. Prices for existing hotels continued in a recovery phase from their lows in the early 1990s, but for some time remained below the cost of new construction and, therefore, discouraged new development that would increase the supply. Budget and other lower-rate hotels were the easiest to finance and quickest to build, and those segments of the market were the first to see indications of over-supply from new construction.

By 1996, occupancy percentage rates in some segments and regions had begun to decline, to be followed inevitably (but not immediately) by lower room rates as owners dropped their rates to attract more guests. RevPAR, in fact, remained high and increased in some areas even with declining occupancy percentages because the strong economy supported higher rates. The increased room rates overcame or cushioned the decline in occupancy, and net income remained strong. The economic impact of oversupply and reduced occupancy was also softened by increased efficiency in operation. Renovations and more sophisticated operating techniques permitted hotel operators to maintain profitability at much lower occupancy percentage levels—known as the “break even” levels—than had been thought possible in earlier periods.[8]

Over-Supply

Unfortunately, over-supply and relative rates of growth of supply and demand were not noted early enough to halt the financing of new development. The financial information and covenants used in underwriting and provided in loan and investment documentation may not have been adequate to identify and track significant adverse business trends. It is now recognized that some markets suffering from over-supply and declining occupancy rates face further impact from new hotels in the construction pipeline.[9] These regions and segments have now been identified by analysts, driving away lenders and investors. “Redlining” of markets seems to be occurring in some areas, making refinancing of existing debt problematic. The inclusion of hotels from such markets in securitization or other pooled investments may now be considered a risk factor. Based on comments received in recent hotel offerings, the Securities and Exchange Commission (SEC) and rating agencies may move toward more detailed asset-by-asset analysis disclosure, taking into consideration local markets when hotel securities are offered for sale.

Competitive Impact

The consequences of over-supply are falling with particular force on regions with a substantial number of non-luxury hotels and low land costs. Within these areas, increasing attention is being devoted to “impact,” the adverse effect of a new hotel on the businesses of other hotels in the same area carrying the same brand or sharing a common reservation system. The growth of multi-brand franchisors such as HFS, Choice and Marriott and their efforts to develop new brands to capture more market niches have made impact a highly contentious issue for owners of hotels in the lower-rate and franchise markets. Impact is also emerging as a theme for franchise regulators.

On the other side of the table, franchisors and brand-name operators are negotiating to insert in their agreements clear rights to compete with their franchisees outside a narrowly defined area around each franchised hotel. Because franchise fees generally are based on gross revenues, franchisors lack an immediate incentive to forego new projects to preserve the profitability of existing franchisees. Impact and the future quality of a brand are also issues for lenders, whose repayment depends on the ultimate refinancing or sale of a hotel at a future date, based on its then-current market share and profitability. While some lenders rely upon a low loan-to-value ratio as their assurance of repayment, lenders and their counsel must be increasingly concerned about whether the owner/borrower has done an adequate job of protecting itself against the competing goals of its operator or franchisor in negotiating the operating or franchise agreements. The lender may also seek direct agreement with the operator and/or franchisor regarding how they would deal with one another after a default under the loan. This is likely to result in direct negotiation between the lender and the third party responsible for the brand operation or franchise.[10]

REITs Retreat

Factors other than over-supply are also contributing to the decline of values. Paired-share hotel REITs have been restricted by new tax legislation, triggering at least one REIT to announce that it will convert to corporate status.[11] Large acquisitions made in 1997 and earlier this year have proven difficult to absorb, resulting in projections of slower or no growth of revenues. Declining revenue growth depressed stock prices, translating to a higher cost of capital if equity was raised by offering new shares to investors. The low cost of debt encouraged some hotel companies to use credit lines for acquisitions and general expenses, with the expectation of replacing the credit line debt with longer term debt or equity when the stock market revived. The drastic decline in the equity markets has made this less feasible. In the same period, bank regulators warned against further expansion of credit given to REITs.[12]

Reacting to all of this, the hotel REITs have retreated as buyers for cash. Some transactions to exchange hotels on a tax-deferred basis for units convertible into REIT stock have been put on hold or abandoned as hotel owners reconsider whether they are willing to take the risk of holding the REIT units unsold for the period required for the tax result. REITs themselves do not want these transactions when the number of shares to be issued in an exchange is so inflated, due to their lower value, that the interests of other shareholders would be diluted.

Pacific Rim Fallout

At the same time that investors and lenders are drawing back from hotels, a substantial number of existing hotels are being put up for sale by Asian investors and banks seeking capital to use in their home regions. The price expectations of these sellers may be unrealistically high, particularly given the terms of the management contracts and financing that are in place for these hotels. The late 1980s represented a period in which management companies requested and obtained contracts extremely favorable to their own interests. In many U.S.-owned and financed hotels, such contracts were restructured or set aside in foreclosure, bankruptcy or other litigation.

In contrast, some of the hotels acquired by foreign investors or financed by foreign lenders continue to operate under terms substantially the same as in the original agreements. The provisions in such outdated agreements may raise obstacles to sale, such as are created by a 50-year or longer term; an obligation to record the agreement against title; a provision that the agreement continue even after default, foreclosure or bankruptcy; an obligation to make very substantial payments upon any termination; and an obligation to respond to unlimited rights to call upon owners for the cash needs of the hotels. In current market conditions, such hotels are extremely difficult to finance or sell, and disappointment on the part of the sellers seems inevitable. While there are good and logical reasons for these hotels not to sell or to sell only at a very low price, the market is unlikely to understand the issues on any subtle level and may only react to the perception that seemingly trophy properties are declining in value. In fact, these failures to sell will be the result of continuing problems arising from matters that were absent from negotiating agreements in the mid-to-late 1980s.

Disputes

As the difficulties now facing the foreign sellers indicate, the competing rights of operator and lender after default continue to be major legal concerns. The questions of whether and how a lender can control revenues and remove an operator after a loan default have become central to a lender's determination of whether it will provide financing for a particular hotel. In the opinion of many lenders, the ability to terminate an operator is crucial to creating the basis for a restructuring or bankruptcy plan. While a management company in 1988 might have demanded a non-disturbance agreement that ensured its continued management after default, the management company in 1998 may be handed an agreement required by the lender that ensures that the management company will not claim offsets, termination fees, tenancy status or any other interest in conflict with the lender after default. Some lenders are approaching franchisors in a similar manner, demanding agreements on how the franchisors will cooperate in the continued operation and eventual sale of hotels after default. The issues addressed in owner-manager and lender-manager agreements will take on increased importance if cash flow diminishes and the coverage for debt service become less ample.

As hotel owners once again realize that their assets are made less valuable by the rights of management companies, we can also anticipate owners and lenders devoting renewed attention to the possibility of termination for default and misconduct by the management company. Lenders were forced to concern themselves with this possibility in the last decade because management agreements seemed to entrench operators against every foreclosure, bankruptcy or restructuring. Realizing that the failure of some hotels was associated with the acts of the management companies, the quality of the brands or the terms of the operating agreements, owners and lender used litigation to deal with otherwise intractable problems. In the last decade there was substantial growth in hotel-related litigation, both in the amount at issue and the complexity of the facts. In addition to "impact," litigation has addressed a number of recurrent themes. Among them are:

1. **The right of an owner or foreclosing lender to terminate a management agreement without cause.** A major decision on this subject was delivered in 1996 in *Government Guarantee Fund of Finland v. Hyatt Corporation,*[13] a Third Circuit decision dealing with a hotel in the U.S. Virgin Islands. The court held that an agency management agreement could be terminated at will by the owner, subject to an obligation to pay monetary damages if the termination was a breach of contract. The management company could not retain its contract by obtaining injunctive relief, and thereby lost one of the most valuable tools that such companies had in negotiations with owners and lenders. A damage remedy was unlikely to be useful in a foreclosure or other default situation because the owner was likely to be insolvent. This decision also placed the burden of demonstrating lost profits or damages on the management companies. The owner was no longer faced with the need to prove misconduct to obtain control of the hotel, which often had proved an impossible task when the management company controlled most or all of the relevant information.

   The battle has now shifted to the question of whether a particular agreement is one of agency or of some other form, such as a lease. New forms of management agreements devote much attention to management companies, who continue to seek to entrench themselves against termination in foreclosures and in disputes with owners. In the absence of clear agreement by the owner and the lender that the management company will be entrenched, a management company may be content to insert into its form relatively subtle provisions that are calculated to burden and delay the lender in controlling the property and taking possession of its revenues.

2. **The right of a management company or franchisor to retain rebates, or "commissions," obtained from vendors dealing with hotels under its management or franchise.** Franchise law has disfavored efforts by franchisors to derive hidden profits or benefits from vendors with whom franchisees have been required to deal as a term of their franchise. Disclosure of all such arrangements is generally required, along with disclosure of how funds contributed for a specified purpose, such as a marketing fund, are actually used. As a result, owners of franchised hotels have had both disclosure and some protection against rebate arrangements that may affect them. In contrast, owners of hotels operated under management agreements have received less disclosure while the use of rebate or commission arrangements has expanded. This has resulted in some litigation arising from the last cyclical downturn. The effects of these charges or hidden costs are, again, not being fully noted by owners so long as income from operations continues to increase. As hotel income starts to fall off, or owners sense that they are not participating sufficiently in the improving results, these charges are again likely to be challenged and their legality questioned. Cases are now pending against some management companies based on general allegations that they have maintained such arrangements in breach of the duty of operators as agents. Challenges to these practices may expand as investors and their counsel look into the causes of under-performing partnership and stock investments. The responsibility of auditors and others for disclosure of such arrangements in securities offerings and financial statements may also be at issue.

3. **The right of a management company to allocate its operating costs and overhead to individual hotels under expense reimbursement or other provisions of a management agreement.** Twenty years ago, the portion of a management company's compensation, described as a "base fee," was understood to be its compensation for the majority of the services it provided. A limited "chain" or "central services" charge might also be authorized for a relatively narrow class of

services, usually including reservation services. Over time, new centrally provided services were developed, and operating departments—such as purchasing departments—were moved from hotels to regional or national offices. Reservation services, marketing and advertising expanded as brand-wide services. At the same time, management companies turned to affiliated companies as suppliers for hotels. Unwilling to absorb the added costs as part of the base fee, management companies began to charge more extensive brand-wide or chain services to individual hotels through a variety of accounting devices, including internal allocations, vendor billings, and reimbursement programs. Once these devices were established, it was mechanically possible to charge through to a hotel a portion of virtually any cost incurred by an affiliate of the management company or by the management company itself, including space costs, and costs of capital and overhead previously compensated by the base fees. Vendors to the brand as a whole, such as suppliers of advertising services or insurance, could be given allocation formulas to use in creating bills for individual hotels. Taken to an extreme, this system allowed a management company to operate a hotel without any long-term capital investment, to recover all of its expenses, and to maintain its own profitability regardless of the performance of the underlying hotel. The base fee assured a profit to the management company because its costs would be recovered regardless of the performance of the hotel.

4. **The obligations of owners to expend or advance new funds for capital expenses or cash shortfalls.** New or newly renovated hotels receiving the cash flow produced by high occupancy and high rates can easily fund their immediate requirements for operating equipment, furniture, and other capital expenses. Aging hotels, five or more years from their last renovation, face difficulty in funding a comprehensive refurbishment or the upgrade necessary to maintain a competitive position against new state-of-the-art hotels. Studies conducted in the last few years have found that the capital cycles of hotels are better understood and are known to require substantially more investment than the 3 percent of gross revenues once used to set mandatory capital reinvestment. Unfortunately, the knowledge has not translated into noticeably better planning. The current cycle of capital began with extensive renovation and refurbishment around 1992 or 1993, with a foreseeable need for substantial new investment in another renewal cycle seven to ten years thereafter. Inevitably, the capital cycle will trigger demands on owners for new funding or additional financing. These demands may be made more intense by a hotel market with declining rates or occupancy percentages, leading also to requests for funds to upgrade hotels. Many management contracts contain provisions requiring owners to fund such costs on demand, but few owners have faced calls in the last few years because there have been ample funds from operations. The delivery of a capital call in a declining market is more likely to trigger litigation than the prompt delivery of funds. Mismanagement, failure to maintain adequate reserves, breaches of covenants to operate at brand standards, and other similar allegations are among the bases of claims asserted in these cases. Capital calls also trigger reexamination of affiliated transactions, including rebates paid to the management companies and overhead allocations that reduce the cash available for distribution and capital reinvestment.

5. **Management companies versus lenders.** When cash flow becomes insufficient to pay both debt service and the needs of the hotel, or the ratio of cash flow to debt service becomes insufficient to permit refinancing on acceptable terms, lenders may seek to remove the management company or to modify its rights in a way that places the lenders' interests first. As lenders read their collateral files more closely under the pressure of a pending default, many will realize that management companies were focused on this potential scenario through the last decade. Management companies have been producing agreements intended to give themselves as much leverage as possible in default situations. Among the tools with which management companies have armed themselves are provisions for exclusive arbitration. Anticipating

adverse publicity and potential challenges to chain-wide practices, some management companies have sought mandatory arbitration in their new agreements. Such provisions are believed to favor management companies by their lack of a public case record, the privacy of proceedings, the likelihood of no award of punitive damages, the possibility of less stringent discovery obligations, and the difficulty of obtaining any preliminary order for the removal of the management company. The last downturn brought many lenders or owners and the management companies into high-stakes litigation, and that experience is likely to be repeated and perhaps intensified in the next years.

What Are the Prospects?

While there are few indications that this cycle will result in a downturn as brutally disruptive to investors and lenders as that experienced in the last cycle, there are, nonetheless, some elements that may prove worse. The hotel industry now seems to rely disproportionately on short-term and credit line debt, suggesting that more lenders and investors will have to deal with loan maturities falling within a relatively short time period. The extensive use of medium- and long-term debt in previous cycles gave many investors time and breathing room so long as they could cover debt service, with the hope of the economy reviving before a loan matured and had to be refinanced under more stringent tests. This built-in delay, and the buffer it created, may now be missing. Further, the availability of sources of debt for the hotel industry is now less predictable. Few of the lenders now most active in the hotel industry—and, in particular, few of the capital market and securitization lenders—have a long history of hotel lending. If the public markets decide that hotel loans do not make desirable assets, the industry as a whole could suffer the impact of "red-lining" treatment, just as sectors of the gaming industry have already suffered. Such a reaction from the public markets and securitization lenders could bring a rapid readjustment to borrowers and investors, with increased litigation and restructuring in reaction to the newly recognized issues.

Endnotes

1. David D. Kirkpatrick and Barbara Martinez, "REIT Interest: Some Say Real Estate Recession Now Likely," Wall St. J., Sept. 2, 1998, at B10.
2. "Hotel Online's List of 80 Lodging and Gaming Stocks," Hotel-Online, http://www.hotel-online.com/Neo/News/Stocks Aug. 31, 1998.html.
3. Professor James Eyster of Cornell University has produced periodic summaries of his database information and publishes updates in real estate finance journals. A number of consulting and accounting firms also maintain databases.
4. This market clearly belongs to Smith Travel Research, whose reports are generally referred to as the STR or "Star" reports. Each hotel participating in the STR database contributes its performance data and a relatively nominal payment in return for receiving comparative statistics on an aggregate of three of more competitive hotels. Originally designed as a means for performance assessment of individual hotels, STR research has become one of the main statistical reference points for the industry. *See, e.g.*, "Hotel Occupancy Rates Lowest in 20 years," 25 Land Use Digest, May 1992 at 2.
5. *See, e.g.,* Jason Ader's explanation of the market segments used by Bear Stearns in tracking hotel performance for its database in "Brand Segment Analysis: An Analytic Tool for the Equity Investor," Lodging Unlimited Quarterly, August 1997. These definitions do not yet appear to have reached the state of common agreement by which they may be used as descriptions of performance standards or hotel quality in legal documents. The Mobil Travel rating system remains the most common, although inexact, set of definitional standards.
6. Bear Stearns and Pricewaterhouse Coopers are among the analysts issuing such reports. Information on hotel construction starts generally is taken from the F.W. Dodge reporting service and combined with STR report market statistics. The economic trend information (inflation, growth, interest rates, etc.) is the same information used by analysts for other forecasts. The proprietary element of the analytic reports is the model by which these elements are related to hotel profitability and value.
7. A "competitive set," as used in reports of Smith Travel Research, is a contractually specified group of hotels whose aggregate results are compared to the individual hotel being evaluated.
8. Historically, occupancy percentages in the low- to mid-60 percent level have been regarded as the minimum level at which hotels can be profitable. Current estimates indicate that the break-even may be around 55 percent, at a time when national occupancies in some segments are only slightly above that level. PricewaterhouseCoopers reports that mid-price hotels are expected to finish 1998 with a 58 percent average occupancy.
9. While the specific list of the most affected markets varies with the publication, analysts appear to view cities such as Orlando and Phoenix to be most prone to further impact. How that impact will fall on existing hotels is unclear. Some indications suggest that the impact will not affect the entire market equally, but will fall most heavily on older properties facing a third or fourth cycle of renovation since their construction.
10. *See, e.g.,* K.C. McDaniel and S. Rosefsky, "Standard Form of Tri-Party Agreement for Hotel Loan," ALI-ABA Assoc. for Cont. Ed., ALI-ABA Course of Study Materials, Modern Real Estate Transactions, August 13, 1997.
11. Starwood Hotels has announced its plans to convert to a "C" corporation.
12. Supervisory letter (SR 98-18) dated June 23, 1998, issued by the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve Bank, as reported July 1, 1998 in the Wall Street Journal. *See also,* "Statement in Response to Supervisory Letter," issued by The National Association of Real Estate Investment Trusts, July 6, 1998.
13. *Government Guarantee Fund of the Republic of Finland v. Hyatt Corp.*, 95 F.3d 291 (3d Cir. 1996)

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Insurance Issues Related to Year 2000 Exposures

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INTRODUCTION

As we rapidly approach the year 2000, the issue of the so-called "Millennium Bug" has gained great attention in the business press and the insurance community. Staggering estimates of the enormity of this problem—both in the costs associated with revising electronic data systems to recognize the chronological progression from 1999 to 2000 and the potential costs associated with the disruption of commerce that could ripple out from data that may be corrupted by this flaw—have prompted insurers and their clients to examine whether relief may be available through their insurance policies. Some estimates place the cost of Year 2000 remediation and litigation in the United States as high as $1 trillion accumulated from 1997 to 2005; the cost of related damages and punitive awards could top $100 billion.

Principally, potential Year 2000 exposures are now being reviewed in the context of the following major insurance lines:

- General liability
- EDP professional (errors and omissions) liability
- Property/time element
- Marine
- Directors' and officers' liability
- Healthcare professionals' liability
- Aviation

Additionally, underwriting intent, policy definitions, endorsements and exclusions are now being studied in each of these areas but, as yet, few clear-cut answers have emerged as to how these forms of insurance may or may not respond to Year 2000 losses. This article briefly summarizes each of these areas and identifies key issues that are likely to be interpreted by the courts as Year 2000 claims materialize.

In nearly all insurance lines, fortuity may become an area of concern in the context of Year 2000 coverage. We anticipate that some underwriters may argue that a fortuitous event must first occur to give rise to a valid claim under an insurance policy. Given the extensive global publicity of Year 2000 computer problems, they may then contend that the Year 2000 topic does not qualify as a fortuity, but is instead a business risk. It is arguable whether underwriters would be able to support that position, especially if insureds can document that they undertook a responsible review of the potential problems and took appropriate remedial action. Under those circumstances, the results from a date change could have been unforeseen.

This example underscores the importance of documenting remedial actions and also suggests that one may consider preparing special reports on Year 2000 compliance activities as part of submitting underwriting renewals. Legal experts also advise that it will be important to maintain complete documentation of remediation efforts now so that effective paper trails will exist to help defend against liability suits arising from Year 2000 events.

Some underwriters, apparently not very confident in relying on a fortuity defense, are contemplating the use of specific exclusions of coverage related to time or date change. Insureds should attempt to resist the imposition of such exclusions and, if necessary, explore any alternatives that may be available.

Litigation Already Under Way

Two of the several lawsuits related to Year 2000 liability that were filed in 1997 illustrate the issue. In *Produce Palace International v. TEC-America Corp.*, Case No. 97 (Michigan, complaint filed June 12, 1997), a Michigan produce market brought an action alleging breach of warranty and breach of contract against a computer system vendor on the grounds that a computer system installed by the defendant in 1995 was unable to process credit cards that expire after the year 2000. This failure allegedly resulted in a loss of income, increased labor costs, and loss of goodwill. *Atlaz International LTD v. Software Business Technologies and SBT Accounting Systems, Inc.*, Case No. 172539 (Calif. Super. Ct., Marin Cty., complaint filed Dec. 2, 1997) is a class action suit against a developer of accounting software alleging breach of warranty. Asserting that the software is unable to recognize and handle the dates starting in the year 2000, the plaintiff is suing on behalf of users of the software for $50 million in fees.

Cases like these are only the tip of the iceberg. Most computer industry analysts predict that, while great efforts are under way to make systems Year 2000-compliant, the range and scope of the problem is greater than can be dealt with completely in the time remaining before the clock turns into the new millennium. And, inasmuch as this is a global issue, Year 2000 litigation will take place in many countries under a wide variety of judicial systems.

Legislative and Regulatory Developments

The discussion of insurance issues is taking place in the context of legislative and regulatory efforts to deal with the Year 2000 situation. New and/or proposed laws and regulations on public disclosure of Year 2000 vulnerability directly influence ongoing debates over whether Year 2000 losses qualify as fortuitous events and the defined responsibilities—and by extension, liabilities—of corporations and their directors and officers.

- Securities and Exchange Commission Bulletin no. 5, issued January 12, 1998, sets forth guidelines for public companies in disclosing anticipated problems and uncertainties associated with Year 2000 compliance. If a company's Year 2000 problems are "material" to its business operations or financial condition without regard to remediation or contigency plans, the company must disclose the nature and potential impact of those problems and any remedial measures it has taken. If the company has not undertaken an assessment of its Year 2000 issues or has not determined their "materiality," it must disclose this uncertainty.
- In November 1997, Senator Bob Bennett (R-UT) introduced a bill (S. 1518) known as the Computer Remediation and Shareholder Protection Act ("CRASH"), that would "require publicly traded corporations to make specific public disclosures in their initial offering statements and quarterly reports regarding the ability of their computer systems to operate after January 1, 2000." Specifically, the Bennett bill would require companies to estimate anticipated Year 2000 litigation costs and liability expenses associated with defending against Year 2000 claims. Further, the bill would require that companies disclose information related to the existence of any insurance policies that cover Year 2000 losses and the defense of Year 2000 legal actions.

At this time, the Year 2000 situation is much like the "pollution issue" that emerged in the insurance industry in the mid-1980s—that is, no one can clearly determine whether coverage exists under current policy language; underwriters are unclear whether specific exclusions are either necessary or, in fact, advisable; and, if exclusions are made, there is no consensus as to how they should be structured.

Unlike the mid-1980s, however, when the insurance market was in the midst of a severe capacity crisis, the current market is highly competitive with carriers offering an abundance of capacity at prices more depressed than ever before. The ultimate resolution, as an industry response to the Millennium Bug, most likely will be determined at negotiating tables with underwriters who are interested in balancing their long-term reputations and market shares with their immediate financial interests.

This article is not intended to be a comprehensive review of all issues associated with the Year 2000 problem. Inasmuch as coverage concerns of insureds and insurers will continue to develop as we approach the turn of the millennium, it is intended to be a "living" document which will be revised and enlarged as the insurance industry continues to react to millennium exposures.

Individual situations will require a specific analysis of exposures and insuring conditions. Coverage interpretations must be referred to your broker and/or to insurers for response. As in all matters of legal interpretation, one should seek the advice of legal counsel for interpretation of one's situation.

GENERAL LIABILITY INSURANCE ISSUES

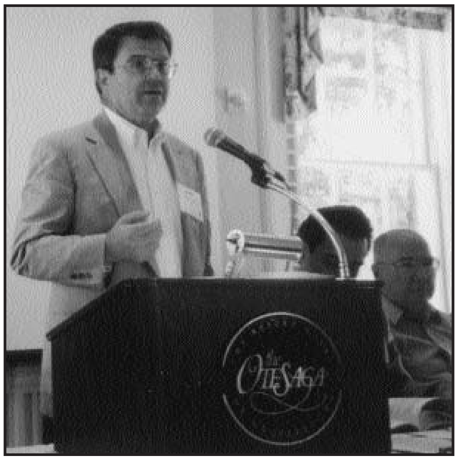
In recent months, the insurance press, insurer publications and newsletters have discussed whether Year 2000 liability coverage exists under standard comprehensive general liability (CGL) policy forms. While opinions on this subject vary, the most common position espoused by underwriters is that coverage for this liability generally *does not exist* under the standard form and was not intended or contemplated in either coverage wordings or rating structures.

Those who hold that coverage is not present usually cite both fortuity and the language in standard coverage exclusions for their positions. Nonetheless, even though such coverage questions may exist, these concerns will not necessarily preclude an insurer's duty to defend, which is generally held to be a broader responsibility under the CGL policy.

Fortuity

An underlying premise in several insurance lines, including CGL, is that coverage is intended to protect the insured against *fortuitous losses*, i.e., losses that are both accidental and unforeseen. Under a CGL policy, coverage is triggered by an "occurrence," which is defined as an accident. Thus, liabilities arising out of the well-publicized Year 2000 issue would not normally be regarded as unforeseen or accidental.

The issue of fortuity is not so clear-cut, however. Under some cir-



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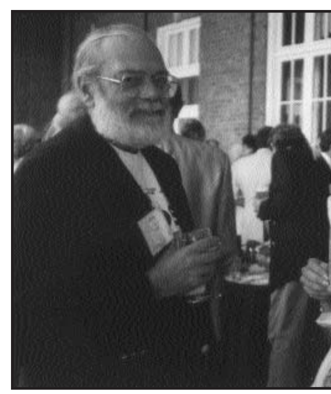

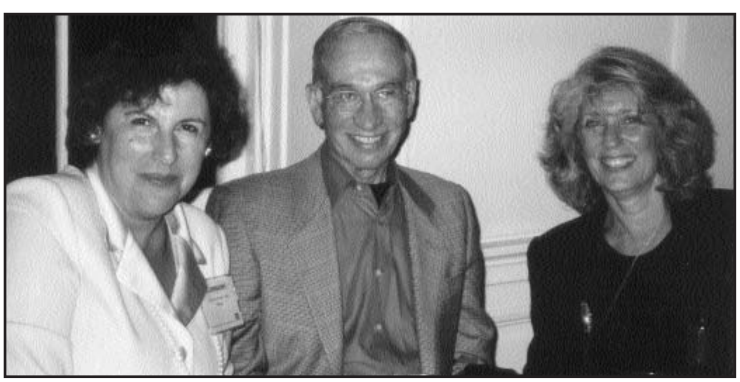

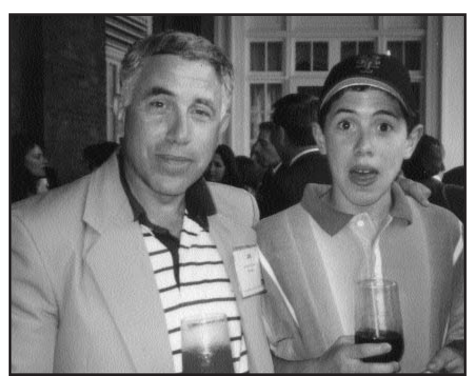

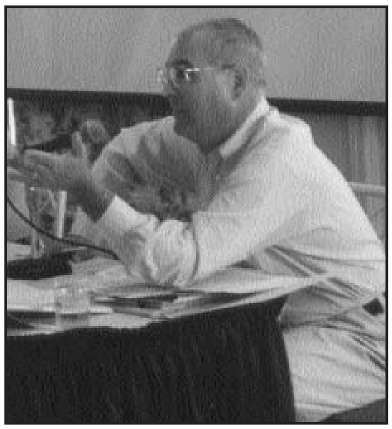

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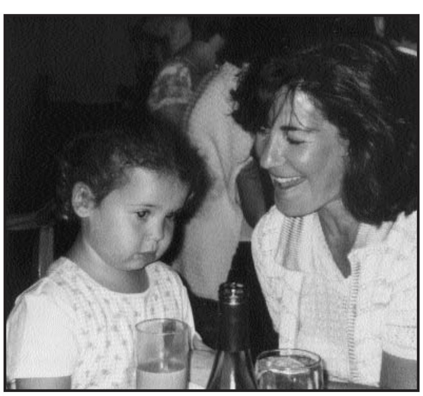

cumstances, it can be argued that a Year 2000 problem may be accidental or unforeseen. Consider an instance where despite an insured's reasonable attempts to identify problems, they remain undiscovered, or where steps are taken to correct an identified situation, but a Year 2000 event still gives rise to liability.

Application of Other Exclusions

In addition to the general question of fortuity, publications, Insurance Services Office (ISO) literature and insurer commentaries often refer to standard policy exclusions that may be interpreted to exclude coverage of Year 2000 liabilities. The exclusions most frequently cited involve "expected or intended injury," "damage to your product," and "damage to impaired property or property not physically injured." Those who hold that coverage is not present in CGL policies argue that the intent of these exclusions has applicability to Year 2000 liability losses.

ISO circulars on this subject cite two scenarios to demonstrate the applicability of the latter two of these exclusions.

- Scenario One: The "damage to your product" exclusion would apply where a computer chip is incorporated into the insured's product as a component part and the failure of the chip causes the product to malfunction. Here, it is likely that the damage to the insured's product would not be covered.
- Scenario Two: If the insured is a computer chip manufacturer, coverage for damage to the product into which it is incorporated may not be covered if the product is considered to be "impaired property or property not physically injured." However, note that there are exceptions to the "impaired property" exclusion involving "sudden and accidental" physical injury to the product.

Limited Coverage Options

To deal with the uncertainty that remains in the Year 2000 issue, the ISO has issued new endorsements to its standard forms. These exclusions, or "limited coverage options," for the CGL form are designed to provide language that better defines the coverage intent. These range from an absolute exclusion to exclusions based on circumstances as follows:

- The most restrictive endorsement, CG 21 60, is intended as a total exclusion for all liability arising out of a computer or computer-related actual or alleged failure, malfunction, inadequacy or inability to correctly recognize, distinguish, interpret or accept the year 2000 and beyond.
- Exclusion CD21 61, for use with CGL and products/completed operations liability policies is limited in nature. It seeks to exclude Year 2000 coverage for products/completed operations, but does not apply the exclusion to the insured's coverage for premises or operations.
- Endorsements CG 04 31 and 32 are intended to provide coverage for specified products, services, or locations.

Use of these endorsements has been approved by the majority of states for use after April 1, 1998. Although some underwriters plan to use these endorsements, at this time it is not anticipated that they will be applied industry-wide.

Excess Liability Issues

While some first-excess policies are designed to replicate coverage defined in the primary policy, many excess policies are not issued on a following form basis but use umbrella policy language that may either be broader or more restrictive. Typically, excess insurers do not subscribe to ISO wordings in their policies, so Year 2000 endorsements, if any, on excess policies are likely to be manuscripted. Variations among the policies of various umbrella underwriters, and among forms which might be issued from the same underwriter for different insureds, dictate the need for programs to be examined on a case-by-case basis in the context of Year 2000 issues.

The existence or extension of Year 2000 coverage through excess layers would be determined by specific provisions in excess policies. Currently, we are aware of no excess carriers who have announced their intent to specifically exclude Year 2000 coverage. Some carriers in the Bermuda market have indicated they do not intend to attach such exclusions to their policies. Other excess liability insurers have apparently concluded that they may be better off remaining silent on the Year 2000 issue rather than excluding it from renewal policies. By removing coverage this year, they may imply that coverage was present in prior years. If insureds then contend that the Millennium Bug actually "occurred" when programming was initially installed, these prior year policies might be called upon to respond.

Looking Ahead

While the applicability of various exclusions in the CGL form will likely be contested over the next several years, the key issue is fortuity. Given this, the most prudent action for any insured is to take all reasonable steps to identify and remedy any Year 2000 problems and to document these activities.

As insurers introduce specific Year 2000 exclusions/endorsements, and where they cannot be avoided, they should be presented to insureds with sufficient time to identify and examine alternatives. To this end, some state regulators have considered applying notice periods.

At this point, it is anticipated that insurers will take several approaches to imposing Year 2000 exclusions, including, but not limited to, applying certain industry groupings, insured size or complexity and individual underwriting characteristics.

EDP PROFESSIONAL (ERRORS AND OMISSIONS) LIABILITY INSURANCE ISSUES

Computer consultants, software designers, and computer product manufacturers normally are subject to professional liability and related exclusions in their CGL policies. Businesses engaged in these fields normally would look to purchase separate insurance to cover these risks. For these insureds, their CGL concerns relate to situations where their product or service does not trigger the occurrence.

Electronics and/or software errors and omissions policies present particular difficulties with respect to Year 2000 issues. Although a relative handful of carriers provide the cover, the primary forms have been created independently, so they vary in scope and design. Recently, insurers of hardware and software producers and consultants have borrowed materially from the forms of the leading writers of errors and omissions (E&O) insurance. In the absence of a common "root" form, or even a common institutional perspective, substantial differences exist among carriers.

Compounding this disparity, each insurer may offer as many as three or four E&O forms of their own creation. A carrier may have different forms for electronics E&O (manufacturers of hardware), software E&O (shrink-wrap software vendors), consultants E&O, as well as a broad, all-inclusive form. Within one carrier's family of forms, variations can be found with respect to coverage, exclusions, etc. Consequently, considering options for an individual risk requires a careful, detailed analysis on a form-by-form basis.

Certain features are, however, universal among the forms. All electronics/software E&O forms are written using claims made to trigger with defined retroactive dates. Further, coverage is provided only for claims first made against the insured during the policy period.

Coverage Grant

At first blush, E&O insurance would appear to be in the area where insureds may find third-party coverage. Indeed, E&O insurance is commonly characterized as "failure to perform" coverage. Also, insurers currently have not added new exclusionary language to the contract carving out Year 2000 exposures, except in very specific cases.

While policy forms vary widely, a representative coverage grant reads:

> "We will pay damages the insured becomes legally obligated to pay for any claim arising out of a negligent act, error or omission, to which this insurance applies, by or on behalf of the insured:
>
> - in the performance of or failure to perform electronic data processing;
> - in the performance of or failure to perform other computer services; or
> - in the failure of software products to perform the function or serve the purpose intended."

Clearly, many Year 2000 claims will be brought on the basis of a software or electronic product's "failure to perform" on or about January 1, 2000. Some claims may be covered under such forms in the absence of new exclusions designed to limit Year 2000 coverage. However, closer examination of forms and their exclusions in the context of potential Year 2000 claims raises other concerns.

The first issue arises directly out of the claims-made nature of the policy. In the form quoted above, the coverage grant further states:

> "This insurance does not apply to any negligent act, error or omission which:
>
> occurred *on or between the Retroactive Date stated in the Declaration of this insurance and the last day of the policy period* stated in the Declaration of this insurance if, on the effective date of this insurance, *the insured had knowledge of or should have known of any circumstances which might have resulted in a claim* . . ." (italics added).

One might argue that the entire world is anticipating Year 2000 problems, so it may be difficult for insureds to take the position that they possessed no knowledge of potential Year 2000 problems in their products or services. All aspects of fortuity apply to E&O insurance as well. Documentation of remediation efforts may help substantiate the insured's position on fortuity and mollify adverse interpretations of this issue.

Not all policies use language similar to that used above, so each form must be carefully discussed with underwriters to obtain written clarification.

Careful negotiation among the insured, the insurer, and the broker must be undertaken to eliminate or clarify language and contracts as they relate to Year 2000. There will be some insureds whose work and/or problems will be the result of activities performed strictly during the policy period, particularly in the case of insureds with multi-year policy periods; but most insureds' problems will arise out of work, in the form of product and/or service performed, sold or created well before the year 2000.

Exclusions

In addition to fortuity and claims-made policy language, a number of exclusions may limit or prevent recovery under E&O policies. Carriers may attempt to add these exclusions over the coming months, so all insureds should carefully examine whether proposed renewal terms include these limitations.

E&O policies typically contain absolute exclusions for bodily injury and property damage. In general, electronics/software E&O policies largely were created to cover areas not addressed or covered by general liability/products liability. Among the areas not covered by general liability is intangible damage. E&O was created, in part, to deal with intangibles such as the loss of magnetic impressions on a disk.

The property damage/bodily injury exclusions will inhibit the recovery of certain losses. Covered claims will be limited to those alleging intangible damage and/or failure to perform. Typically, specific allegations of tangible property damage and/or bodily injury have not been covered under any circumstances by E&O policies.

E&O policies contain language similar to the following example:

> "This insurance does not apply to any claim which results from an act that:
>
> - is intended by the insured; or
> - can be expected from the standpoint of a reasonable person to cause damage, even if the damage is of a different degree or type than actually intended or expected."

The expected or intended damage exclusion once again raises the issue of fortuity. It is likely that some claims will fall victim to this exclusion. All other exclusions in the policy should also be explored in the context of Year 2000 issues.

Summary

While many insureds may be relying on E&O coverage to provide relief from potential Year 2000 losses, a number of problems inherent in policy structures and language may limit or prevent recovery of Year 2000 E&O claims by insureds. Insureds need to understand these E&O policy limitations.

Although much can be done to evaluate each policy, modify coverage, and obtain clarification from insurers, the forms currently available should not be relied upon to provide Year 2000 coverage. There is substantial variation among policies of different insurers and within a given insurer's family of policies.

As insurers are only now beginning to evaluate much more closely the Year 2000 issues of insureds and prospective insureds, some are being declined. We anticipate that form modifications may well emerge in the near term.

PROPERTY/BOILER & MACHINERY INSURANCE ISSUES

The potential financial impact of Year 2000 losses could easily dwarf any historical catastrophe losses heretofore paid by the insurance industry; and property insurance may weather the brunt of this electronic storm as the most likely repository of Year 2000 claims. While physical damage exposures related to Year 2000 issues are relatively minor, "business interruption" exposures are potentially enormous.

As in other areas of insurance, debate over whether property/boiler and machinery insurance policies, as currently written, cover—or are intended to cover—Year 2000 losses centers mainly on fortuity and other definitions that trigger coverage.

Fortuity

The first test of coverage in a property policy is the presence of fortuity in the risk of loss. Fortuitous events or losses are those which are either sudden and unforeseen or, more formally, are dependent on chance. As in other areas of insurance, property underwriters may argue that Year 2000 losses can not be classified as fortuitous events since the issue and its ramifications have been subject to widespread publicity and, indeed, to regulatory controls regarding measurement and disclosure. Those insureds who have chosen not to undertake Year 2000 remediation may find it more difficult to substantiate the fortuitous (accidental) nature of a Year 2000 loss than would those who can document that they diligently sought to rectify their Year 2000 exposures.

Physical Damage

After fortuity, the essential property coverage trigger is whether or not the event involves a *covered* *peril* that has *caused physical damage* to the property insured. The peril trigger differs depending on the type of policy in question. Unless a "named peril" policy specifically names Year 2000 as a covered peril, it would not likely be covered under this form. In contrast, "all risk" policy forms are designed to cover all perils that are not identified as excluded in the policy. Interpretation of these exclusions in the context of Year 2000 risks then becomes the key issue. For example, standard all risk policies exclude all losses arising from faulty workmanship, materials or design; it may be argued that the inability of a data system to recognize the year 2000 in its programming is a design flaw and, thus, is not covered under such a policy. Comprehensive boiler and machinery policies, like the all risk property form, are designed to cover losses that are not specifically excluded.

Next, one must address whether or not physical damage has been suffered. Underwriters who would argue that Year 2000 losses are not covered will note the difficulty in proving "physical damage" resulting from a Year 2000 event because they do not consider corrupted data to be physical damage.

Another interpretation, however, could arise under a scenario where there is solid evidence that a fire or other covered peril resulted from a Year 2000 event and policy wording provides coverage for such a loss, but not to rectify the Year 2000 defect in the programming or systems. In this instance, the insurance will only pay the cost to restore the equipment to its original pre-loss condition. Similarly, in a boiler and machinery policy, if the failure of a computer system to recognize the year 2000 then causes high-speed production equipment to suddenly stop, causing the machinery to be torn asunder (physical damage), absent any explicit Year 2000 exclusion, the downstream loss would likely be covered but the cost to rectify the data system that caused the loss would not.

Time Element

Under property damage and boiler and machinery policies, the presence or absence of physical damage not only determines the potential for recovering for the value of damaged property, but also for recovery for business interruption, extra expense, and other time element losses. Coverage depends upon whether the interruption of business came as a direct result of an insured event. And, as with physical damage, the defined period or period of interruption typically is only for the time to restore the property to its condition that existed prior to the loss.

"Contingent business interruption" loss or damage also must be of the type insured by the policy (i.e., fortuitous and involving physical damage from an insured peril). Therefore, even if one rectifies an organization's Year 2000 system issues, losses suffered as a result of Year 2000 problems encountered by suppliers or customers may not be insured.

Possible Loss Scenarios

Coverage is more clearly defined for instances where the Millennium Bug would produce a series of events that cause physical damage to covered property and the damage is caused by a covered peril (in the case of a named peril policy) or by a peril not excluded, in the case of an all risk policy. Thus, if the Millennium Bug were to initiate a series of events that resulted, for example, in a fire, explosion, or sprinkler leakage, there would be a strong case for recovery for physical damage to covered property as well as for any attendant time element loss. One must be aware, however, that concurrent causation language in a policy may serve to negate coverage in this type of event.

Less certain is the potential treatment of damage, derangement, or corruption of computer data and the business interruption that may be a consequence. Although many manuscript property insurance policies have incorporated wording to clarify such occurrences as physical damage in an attempt to afford coverage against computer viruses, it is likely their insurers will argue that any such damage caused by a Millennium Bug is not fortuitous.

The definition of "occurrences" in the Year 2000 context is also cloudy. If one Millennium Bug is the proximate cause of several losses in several locations, how many events have occurred? This is the key issue when considering the applicability of deductibles and per loss limits in a policy. This is also a critical concern in placements involving multiple carriers, particularly in layered placements. Lack of unanimity among carriers with respect to the definition of "occurrence" will inevitably lead to coverage disputes.

While Year 2000 problems have been widely debated, studied, and discussed, their potential results and manifestations are exceedingly complex. It is virtually impossible to catalog all potential problems in advance or to interpret the variety of possible loss scenarios as they may apply to the myriad of property policies. No doubt, the courts will be called upon extensively to sort out close issues as they arise.

Property/Boiler and Machinery Insurance Industry Reactions

While no industry sources have floated what can be deemed as reliable potential loss estimates, the enormity of estimated rectification and litigation costs to business in general has driven many property insurers to propose clarifying or adding exclusionary language to policies. The scope and variety of exclusionary language now being proposed by underwriters ranges from absolute and total Year 2000 exclusions for any damage (direct, indirect, consequential, and concurrent), to those which seek to clarify that the intent of the policy is to cover physical damage arising from the Millennium Bug but not to include coverage for the cost of rectifying the consequences of the bug. There are, of course, many variations in between.

ISO endorsements generally seek to restrict coverage to damage resulting from a covered cause of loss in ISO property and property-related policies. With respect to time element policies, ISO offers a coverage grant for computer failure, but limits the amount of recovery to no more than $25,000 in any one policy year.

D&O LIABILITY INSURANCE ISSUES

D&O carriers continue to become more concerned and focused on the Year 2000 issue, particularly now that many multi-year D&O placements are scheduled to expire around the year 2000. Underwriter concerns have been further heightened since the January 12, 1998 release of the SEC's revised Bulletin no. 5 (available on the Internet at www.sec.gov) wherein the SEC outlines disclosure requirements associated with Year 2000 anticipated/projected expenses.

At this point, most carriers do not require exclusions on policies, although some are "proposing" exclusions on individual accounts. While many are now requesting Year 2000 information from insureds through questionnaires at renewal, most carriers would concede that their current policy forms, subject to their terms, conditions, and exclusions, and absent any specific Year 2000 exclusions, do provide coverage for Year 2000 D&O claims.

D&O policies typically do not have Year 2000 exclusions. Accordingly, the fact that a claim arises from a Year 2000 problem would not, by itself, warrant denial of coverage by a carrier. We expect, however, that the allocation issue will arise in the context of many non-securities claims, as the entity is typically an insured under the policy only for securities claims.

Fortuity

Some carriers nonetheless may seek to deny Year 2000 coverage on the basis that the directors and officers were aware of their company's potential Year 2000 problems well in advance of the claim but did not adequately address that exposure. Thus, it could be argued that these claims would not be considered fortuitous and would not be covered by the insurance contract. This position relies on the premise that only non-fortuitous claims are appropriately covered by insurance contracts and that it would be against public policy to do otherwise. In addition, the insurer could argue that such coverage was never intended, although this argument may be difficult to sustain. In contrast, however, it can be noted that D&O insurers have been aware of the Year 2000 problem for years and, therefore, have had ample opportunity to address the issue in their policies, by exclusion or otherwise.

Anticipated Sources of Year 2000 Claims

Year 2000 D&O claims may take various forms including, but not limited to, the following:

- Securities class actions: Shareholders allege that, for example, directors and officers failed to properly disclose the existence, magnitude, or effect of the Year 2000 problem in public documents;
- Shareholder derivative suits: Filed on behalf of the corporation against directors and officers, they allege breach of duty of care and/or waste of corporate assets because the directors and officers failed to identify, evaluate, respond to, or test solutions to the Year 2000 problem on a timely basis; or
- Breach of contract claims: Filed by customers or other third parties alleging that the company's failure to become Year 2000-compliant caused the party a financial loss.

Carrier Year 2000 Questionnaires

Increasingly, underwriters are seeking information through questionnaires targeted to detect, among other things, the Year 2000 compliance of a client or their vendors, suppliers, or customers, whether or not the company has engaged a third-party firm to assess its potential liabilities, the level of the board of directors' involvement, and management of its vendors for Year 2000 readiness.

Before completing these questionnaires, the forms should be carefully reviewed to identify any warranty-type questions that may affect coverage or any representations that may be used against a client in the event of a claim. In lieu of a questionnaire, it may be best to offer the underwriter a conference call and/or a face-to-face meeting so the questions may be answered orally. If a questionnaire must be completed, be certain that there are no warranty questions and that the questionnaire will not be a part of either the application or the policy. This is best accomplished via an up-front discussion with the underwriter, followed by a letter stating that the questionnaire is "provided with the understanding that it is for informational purposes only and will not be made a part of the proposal for insurance or the policy form." The underwriter should be asked to sign this letter and return it prior to the completion of a questionnaire. Furthermore, if a signature is required as part of a questionnaire, severability should be specified and care should be taken in selecting the signer.

Notice of Potential Claim

Some attorneys are advising clients to consider putting their carriers on notice of circumstances that may give rise to a claim prior to any Year 2000 exclusions being put on the policy. At first glance this might appear to be a potentially viable way to "lock in" coverage under the existing policy; however, there may be difficulties with this approach. Many insurance policies require notice of potential claim to be very specific. To the extent that a company files a notice of potential claim that is vague or incomplete concerning its Year 2000 liability, it is possible for the insurer to argue that the notice is insufficient to trigger coverage. If a notice of potential claim is not accepted by an existing carrier, and that carrier does not renew, a new carrier may still assert that coverage is excluded under the "prior notice" exclusion of the policy, thus resulting in a potential coverage gap.

Exclusions

While there may be no specific exclusions in the D&O policy for Year 2000 claims, other policy exclusions could be used by a carrier to deny a claim. For example, if it is adjudicated that the directors and officers of the insured organization were dishonest or fraudulent in their dealings on the Year 2000 issues facing the firm, there would be no coverage. Another exclusion in the policy eliminates coverage for claims wherein the wrongful act resulted in a personal profit for the directors and officers that was illegally obtained. Other pertinent provisions to consider include the ERISA, prior notice, prior and pending litigation, and prior acts exclusions as well. In each of these situations, and others, properly constructed policy language can substantially benefit insureds.

Looking Ahead

Insureds must be cautious as they deal with underwriters on directors and officers liability renewals. Multi-year aggregates that go beyond Year 2000 should be given strong consideration, as the market is not dictating that Year 2000 exclusions be put on policies at this time. During renewal negotiations, insureds should be careful not to prejudice their claims position through representations made during the underwriting process. And finally, since there are no guarantees of coverage for Year 2000-related claims under existing policies, it is important that insureds partner with an experienced broker to address the coverage complexities surrounding the Year 2000 issue and to develop D&O insurance programs that can best meet their needs.

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Whither the Consolidation Agreement? The Consolidated Note Triumphant

by Joseph P. Forte*
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Real estate lawyers today are keenly aware of the continuing intrusion of the capital markets on real estate. Witness the growth of real estate investment trusts and commercial mortgage-backed securities (CMBSs). With more than $44 billion in CMBSs issued in 1997 (and probably more this year), the impact of capital markets is increasingly being felt in commercial real estate finance.

With the variations of securities disclosure in local law and practice and the use of state-specific loan documents, the vagaries of local law and practice are routinely observed by capital markets transactions, although additional (albeit uniform) requirements are often imposed by credit rating agencies and the ultimate CMBS investors. For example, in the 1980s FNMA developed its own form of consolidation agreement for multi-family loans—which simply attached the newest form of uniform note and mortgage—to conform to existing New York practice. Yet, the size and strength of the national market may have a significant impact upon customs and practices in a local market. This has most often occurred when federal legislation has been enacted to preempt state law, e.g., federal exemption of state usury and prepayment limitations. This is a direct result of obvious prejudice by capital markets toward a unified national view of markets.

Certain corporate trustees and/or custodians in CMBS transactions have continually raised documentation exceptions for New York mortgage loans deposited in a collateral pool trust because the mortgage notes are endorsed to neither prior intermediate assignees nor the ultimate assignee—the trustee/custodian. Unlike other states, it has long been the custom and practice in New York mortgage loan transfers that the assignor/transferor of a mortgage loan not endorse the mortgage notes being assigned. The mortgage loan is transferred by an assignment of the mortgage that contains the statutory language that it is assigned ". . .together with the bond or obligation described in said mortgage, and the moneys due and to grow due thereon with the interest. . ."[1]

Background

In New York, bonds were originally the usual evidence of real estate secured debt. New York real property law recognized "bonds and mortgages,"[2] as did banking and insurance company investment statutes.[3] Mortgage bonds were not traditionally transferred by indorsement but by delivery of the bond and an assignment of the mortgage together with the bond.

Because the use of corporate entities was the preferred means of avoiding personal liability for owners and usury risk for lenders, lenders in New York were concerned after enactment of the corporate bond tax in 1906 that mortgage bonds (of corporate borrowers) might be subject to the tax. To avoid this risk, the practice, therefore, developed of using promissory notes rather than bonds to evidence real estate debt. To conform the law to this developing practice, the various investment authority statutes governing New York chartered financial institutions were amended to allow investment in "notes and mortgages" as well as "bonds and mortgages," *e.g.,* N.Y. Banking Law section 235. Because existing mortgage bonds were assigned (or retained upon a refinancing) to avoid further imposition of the New York mortgage tax, a single consolidated mortgage loan on a New York property might be evidenced by several prior existing bonds as well as promissory notes. Because the existing bonds had not been endorsed, this practice was continued with respect to the new promissory notes being used in subsequent refinancings and additional financings. To date, the custom and practice of transferring mortgage loans by assignment of the mortgage together with the "bond, note or other obligation" instead of by indorsement has continued and is routinely insured by the title insurance industry in New York. Given the large number of earlier unendorsed bonds and notes in the chain assigned for mortgage tax purposes and the potential risk of the imposition of the mortgage tax for a *replacement* note (especially if the old bonds and notes are returned to the borrower), the more conservative lending practice has been to assign existing mortgage bonds and promissory notes to the new lender, consolidate the indebtedness and the mortgage liens and restate the payment terms of the indebtedness in a separate recordable Consolidation Agreement.

Without addressing the possible benefits of negotiability under the UCC in a CMBS transaction, it is well settled law that "[i]f the 'assignment' also mentions that the debt is being transferred . . . the transfer is unquestionably complete."[4]

Knowledgeable investors in the primary and secondary mortgage markets, as well as the title insurance industry, have long recognized that the New York practice of not endorsing promissory notes take legal comfort in almost 90 years of real estate practice in one of the largest and most sophisticated real estate markets in the country. For CMBS trustees/custodians, however, it is not a question of legal "comfort"—they are looking for uniformity in documentation and process. With low trustee/custodian fees, a checklist mentality arises which cannot abide variations from the perceived norm. Thus, unendorsed promissory notes, as well as consolidation agreements, are listed by trustee/custodians as exceptions to the good delivery of a particular mortgage loan file being deposited in the CMBS trust. Resolving these exception lists only causes additional work and expense for the issuer/depositor to the trust, who must explain this accepted local practice to the trustee/custodian and convince it to omit its documentation exception to good delivery.

With the amendment to section 274 of the N.Y Real Property Law, which eliminated the borrower's right to require the mandatory delivery of assignments by lenders, many single-family residential lenders in New York now refuse to accept assignments of existing mortgages because eliminating prior mortgages (as well as notes and interim assignments) reduces excess documentation and creates more uniform loan files for sale in the capital markets. Of course, retaining old bonds and notes, as well as mortgages, increases the likelihood of one or more documents being lost, misfiled or inadvertently destroyed or discarded.

To avoid this additional cost and risk, some New York lenders occasionally have resorted to using a consolidated note with a consolidation clause in the new mortgage for any additional new loan.

The following provisions are based directly on the forms of consolidated note and mortgage consolidation clauses developed by H. Jackson Sillcocks of Trubin Sillcocks Edelman & Knapp in the mid-1970s. His proposed forms were responsive to concerns expressed at that time by the title insurance industry and to the recognized position of the State Tax Commission. Jack Sillcocks had two specific caveats to using the consolidated note: It should never be characterized as a replacement note, and the original existing notes should never be marked "paid," "destroyed" or "returned to the current borrower," but should be retained by the lender as continuing evidence of the existing original indebtedness. In addition, his consolidated mortgage did *not* require that the lender execute the mortgage but simply had the lender evidence its agreement to consolidation of the existing and new mortgages "[b]y accepting this [new] Mortgage . . . ."

Over the years, the Sillcocks form of consolidated note and mortgage has been used by several lenders in a variety of transactions but has never supplanted the consolidation agreement in general usage. Today, however, with the continuing growth of capital markets and influence of national CMBS trustees/custodians, the use of the consolidated note and mortgage with consolidation would serve to conform New York practice more closely to the national model. Endorsing the consolidated note would alleviate the ill-founded concerns of trustees/custodians in CMBS transactions and would help New York loans to avoid standing out in pools.

To this end, updated versions of Sillcocks' suggested modifications have been used to create a "Consolidated Promissory Note" and mortgage consolidation provisions that should be acceptable both to the primary and the secondary markets.

Since the note will be made in the full consolidated amount, the following new paragraph should be added after the customary "promise to pay" paragraph:

> This Note evidences the new and additional indebtedness of $__________ recited in the Mortgage (as defined below) as being secured thereby and also the existing indebtedness of $__________ remaining unpaid on, and previously evidenced by, the bond(s), note(s) or obligations secured by the [__________] certain mortgage(s) [contemporaneously assigned to/held by Mortgagee] and described in the attached Schedule; it being the intention of this Note that it shall constitute both a renewal, extension and modification of the terms of payment of such existing indebtedness and also an expression of the terms of payment of such new and additional indebtedness.

In addition, the reference to the mortgage in the note should be modified to provide that:

> "the Mortgage by its terms, is consolidated with __________ other mortgage(s), [which the Mortgagor has caused to be assigned contemporaneously to the Mortgagee]";

The new mortgage to be consolidated should be modified to reflect this consolidation structure.

The mortgage should be divided into two parts: Part A, the new "Mortgage and Security Agreement," and Part B, the "Consolidation, Modification and Restatement Agreement." Each has its own recitals and terms. Part A should be modified by incorporating (or substituting) the following recitals at the beginning of the mortgage.

Part A—Mortgage and Security Agreement

Recitals:

Mortgagor desires to secure the payment of new indebtedness in the sum of ______________________ AND 00/100 DOLLARS ($____________) (the "New Indebtedness") and the other monetary obligations set forth in Section __ and the performance of all of its nonmonetary obligations under the Note (as defined below) and the Other Obligations (as defined in Article ___).

Mortgagor, by its Consolidated Promissory Note of even date herewith given to Mortgagee, is indebted to Mortgagee in the aggregate principal sum of _________________ AND 00/100 DOLLARS ($______________) (the "Loan") (the note, together with all modifications, substitutions and amendments thereof, shall collectively be referred to as the "Note"). The Note evidences the New Indebtedness secured hereby, together with the renewal, confirmation, extension, modification and restatement of an existing indebtedness of $____________ (the "Existing Indebtedness") evidenced by the existing bond(s), note(s) or obligation(s) (the "Existing Notes") secured by the "Existing Mortgage(s)" (as defined in Part B below), with interest from the date thereof at the rates set forth in the Note, principal and interest to be payable in accordance with the terms and conditions provided in the Note.

In addition, a new Part B containing the consolidation provisions should be incorporated after the mortgage. The following is a form Part B that has been used in New York with the review and approval of several title insurance companies.

Part B—Consolidation, Modification and Restatement Agreement

Recitals:

Mortgagee is the owner and holder [by contemporaneous assignment] of ______ other mortgage(s) listed on Schedule A attached hereto (the "Existing Mortgage(s)") covering [all or part of] the Property and the Existing Note(s) which such Existing Mortgage(s) [was/were] given to secure and on which there now remains unpaid the Existing Indebtedness.

Mortgagor and Mortgagee desire (a) to combine and consolidate the liens of the Mortgage set forth in Part A (the "New Mortgage") and the Existing Mortgage(s), so as to create solely one lien covering the Property and (b) to restate the terms and conditions of the Existing Mortgage(s) in their entirety in the manner set forth below:

Mortgagor, And Mortgagee, By Accepting The New Mortgage, Hereby Agree As Follows:

Paragraph 1 *Lien Consolidation*. The New Mortgage is hereby combined and consolidated with the Existing Mortgage(s) so that together they shall constitute a single lien and interest on the Property in the amount of the Note, with the same intent and like effect as if one first mortgage covering the Property had been executed and delivered by Mortgagor to Mortgagee to secure the Existing Indebtedness and the New Indebtedness and the payment and performance of all other monetary and non-monetary obligations set forth in Paragraph 2 (the "Consolidated Mortgage").

Paragraph 2 *Debt Consolidation*. The Consolidated Mortgage secures the payment of the following, in such order of priority as Mortgagee may determine in its sole discretion (the "Consolidated Debt"):

1. the Existing Indebtedness confirmed by, and the New Indebtedness evidenced by, the Note in lawful money of the United States of America;
2. interest, default interest, late charges and other sums applicable to the Consolidated Debt as provided in the Note and this Consolidated Mortgage;
3. the Prepayment Consideration, if any;
4. all other moneys agreed or provided to be paid by Mortgagor in the Note and the Consolidated Mortgage;
5. all sums advanced pursuant to the Consolidated Mortgage to protect and preserve the Property and the lien and the security interest created hereby; and
6. all sums advanced and costs and expenses incurred by Mortgagee in connection with the Consolidated Debt or any part thereof, any renewal, extension, or change of or substitution for the Consolidated Debt or any part thereof, or the acquisition or perfection of the security therefor, whether made or incurred at the request of Mortgagor or Mortgagee.

Paragraph 3 *MODIFICATION AND RESTATEMENT*. The terms and provisions of the Existing Mortgage(s) and Existing Note(s) are hereby restated, and except for the principal amount(s) secured or evidenced thereby, all of the terms and provisions contained in the New Mortgage and the Note shall replace and supercede the terms and provisions of the Existing Mortgage(s) and Existing Note(s) and shall be deemed to be the terms thereof as if fully set forth therein.

Paragraph 4 *SPREADING OF MORTGAGE(S)*. The Consolidated Mortgage and the lien thereof is hereby spread to cover those portions of the Property not already covered thereby.

Paragraph 5 *ESTOPPEL*. The Consolidated Mortgage is a valid first lien in the amount of the Consolidated Debt payable as set forth in the Note, and there are no offsets, counterclaims or defenses to the Consolidated Mortgage or to the Consolidated Debt secured thereby.

Paragraph 6 *MAXIMUM AMOUNT SECURED*. Notwithstanding anything contained herein to the contrary, the maximum amount of principal indebtedness secured by this Consolidated Mortgage at the time of execution hereof or which under any contingency may become secured by this Consolidated Mortgage at any time hereafter is $[the Consolidated Debt], plus (a) Taxes; (b) Insurance Premiums; (c) expenses incurred in upholding the lien of the Consolidated Mortgage including, but not limited to: (1) the expenses of any litigation to prosecute or defend the rights and lien created by the Consolidated Mortgage; (2) any amount, cost or charges to which the Consolidated Debt becomes subrogated, upon payment, whether under recognized principles of law or equity, or under express statutory authority and (3) interest at the Default Rate or the Applicable Interest Rate.

Paragraph 7 *DEFINITIONS*. Unless otherwise defined in this Consolidation Agreement, all capitalized terms shall have the meaning set forth in the New Mortgage contained in Part A.

Paragraph 8 *GOVERNING LAW*. This Consolidation Agreement shall be governed, construed, applied and enforced in accordance with the laws of the State of New York.

Although Part B contains a "*Maximum Amount Secured* " provision for the Consolidated Debt, counsel from several title companies have suggested inserting this provision in Part A for the new indebtedness secured by the Mortgage.

This format for a "Consolidated Note" and "Mortgage and Security Agreement, and Consolidation, Modification and Restatement Agreement" would serve to update New York practice by eliminating the use of the separate consolidation agreement and allowing for endorsement on the consolidated note. These changes would be welcome in the secondary mortgage market as a step toward a more uniform practice, eliminating trustee/custodian concerns and reducing the costs to CMBS issuers.

Endnotes

1. N.Y. Real Prop. Law § 258, Schedule O.
2. N.Y. Real Prop. Law § 258, Schedule N.
3. N.Y. Banking Law § 235.
4. Nelson and Whitman, *Real Estate Finance Law* (2d ed 1985), 366.

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BERGMAN ON MORTGAGE FORECLOSURES . . .

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Lis Pendens and the Order of Reference*

The predilections of two or three upstate judges does not an epidemic make, but when demands—they could more politely be called requests but some weren't—upset solidly accepted precepts, discomfort suggests exposing the misapprehension. Speeding to the point, a filed *lis pendens* is not a requirement to issuing an order of reference. Mandating proof of an extant *lis pendens is* at variance with both RPAPL and the CPLR, but some judges have done just that. Although most of the time such insistence will not be overly burdensome, because a *lis pendens* is most often filed with the summons and complaint, sometimes it does present a problem. (And why should judges routinely ask for something which isn't necessary?) In any event, it adds time to the foreclosure process which, with interest accruing daily, is antithetical to the goal of keeping the mortgage debt as small as possible.[1]

To be sure, it is generally accepted that the better practice is to file the *lis pendens* at the inception of the action because of its basic effect.[2] It serves as constructive notice to the world that the foreclosure is pending. In turn, it binds all subsequent encumbrancers or purchasers as if they had been made parties to the action. The practical significance of the latter maxim is considerable. Once the foreclosure search (and its continuation) is completed, to the moment of filing the *lis pendens* that the mortgaged premises may be sold, remortgaged or further encumbered, is of no legal consequence to the plaintiff. There is no need to regularly run searches during the life of a foreclosure because the filed *lis pendens* means that those subsequent interests will be extinguished by the foreclosure sale just as if they had been named and served in the foreclosure.

That a *lis pendens* will typically be filed with the summons and complaint does, however, have a meaningful disadvantage: if the defendant (effectively, the property owner[3]) is not served within 30 days of the filing, cancellation of the *lis pendens* is mandatory, albeit upon motion of an aggrieved party.[4] To partially digress, the cited disadvantage absolutely was so under prior practice when a mortgagee could opt to file a *lis pendens* prior to commencing a foreclosure. But before 1992, of course, commencement of an action occurred upon service of process. Since then, however, commencement is achieved upon filing the summons and complaint with the county clerk,[5] thus creating a clash between the service within 120 days rule[6] and the 30-day imperative.

Assuming, though, that the 30-day obligation still prevails,[7] upon application for an order of reference, it is possible that the defendant may not have been served within 30 days, in which event a judge might believe that proof (as opposed to a standard recitation in an affirmation or affidavit of regularity) of *lis pendens* filing somehow becomes germane to issuing the order of reference.

But a *lis pendens* wasn't required in the first instance. If it *was* filed, although cancellation is mandatory, it has to be on motion. Even if such a motion were made and granted, in a foreclosure action, the plaintiff has an absolute right to file a new *lis pendens*[8] so that any possible question here is banished.

Finally, even assuming failure to serve the summons within the commanded 30-day time period—such as if the property owner was served on the 35th day—the neglect nullifies only the *lis pendens* and has no effect on the underlying jurisdiction of the court to try the foreclosure action.[9] Where, then, could there be *any* necessity to prove filing of a *lis pendens*?

In the end, the sole, although compelling, requirement for a *lis pendens* in the foreclosure action is that it must be filed at least 20 days prior to entry of the judgment of foreclosure and sale.[10] (Obviously that has nothing to do with the list pendens.) If that is the only time filing a *lis pendens* in the foreclosure sale is mandatory—and it is—any basis to dictate proof of its filing earlier, for example, as a condition for an order of reference, is simply groundless. Whether judicial discretion encompasses demands which clearly do violence to a statute is a philosophical issue, that will not be addressed here. But if such discretion does support what is otherwise unsupportable, it should nevertheless be avoided. Adding any more time and expense to already protracted foreclosure actions in New York—without discernible purpose—seems conspicuously inappropriate.

Endnotes

1. It is always worth noting that the lower the mortgage debt, the lesser the chance (or the quantum) of any deficiency (which hurts both mortgagor and mortgagee, but the former more) and the greater the chance (or the quantum) of a surplus.
2. CPLR § 6501; *See also* 1 *Bergman on New York Mortgage Foreclosures* § 15.08[1], Matthew Bender & Co., Inc. (rev. 1997).
3. CPLR § 6512; *See also* 1 *Bergman on New York Mortgage Foreclosures* § 15.06, Matthew Bender & Co., Inc. (rev. 1997).
4. CPLR § 6514(a). For a further discussion, see 1 *Bergman on New York Mortgage Foreclosures* § 15.04[2][b], Matthew Bender & Co., Inc. (rev. 1997).
5. CPLR § 304.
6. CPLR §306-b(a)
7. See 1 *Bergman on New York Mortgage Foreclosures* § 15.04[b][d], Matthew Bender & Co., Inc. (rev. 1997).
8. *Slutsky v. Blooming Grove Inn*, 147 A.D.2d 208, 542 N.Y.S.2d 721 (2d Dep't 1989).
9. *Cohen v. Biber*, 123 A.D. 528, 108 N.Y.S. 249 (2d Dep't 1908); *Brandow v. Vroman*, 22 Misc. 370, 50 N.Y.S. 323 (1898), *rev'd. on other grounds*, 29 A.D. 597, 51 N.Y.S. 943 (3d Dep't 1898).
10. RPAPL §1331; *Slutsky v. Blooming Grove Inn*, *supra* at note 7, *citing Robbins v. Goldstein*, 36 A.D.2d 730, 320 N.Y.S.2d 553; *Isaias v. Eischof*, 37 A.D.2d 934, 326 N.Y.S.2d 291.

****Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (Rev. 1998), is a partner with Certilman Balin Adler & Hyman in East Meadow, New York, outside counsel to a number of major lenders and servicers. He also is an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute, where he teaches the mortgage foreclosure course. Additionally, he is a member of the USFN and the American College of Real Estate Lawyers, and he is on the faculty of the Mortgage Bankers Association of America School of Mortgage Banking.**

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Recent Cases of Interest

The following case summaries were prepared by members of the St. John's University School of Law Real Property Law Society.

Tenants-in-Common and Adverse Possession: Real Property Actions and Proceedings Law section 541 requires 20 years of continuous exclusive possession before a co-tenant can acquire title by adverse possession. *Charles Alexander Myers v. Thelma Bartholomew, et al.*, 91 N.Y.2d 630, 674 N.Y.S.2d 259 (1998).

Facts: Appellant, Charles Alexander Myers, as a tenant-in-common in exclusive possession of a two-family residence on Bushwick Avenue in Brooklyn for 13 years, sought to establish his title by adverse possession. Respondents, Thelma Bartholomew and her three daughters, as non-possessory co-tenants, asserted that under section 541 of the Real Property Actions and Proceedings Law (RPAPL), the appellant's claim of adverse possession required a period of 20 years of exclusive possession.[1]

In 1959, respondents' husband and father, Aston Bartholomew, and appellant's wife, Julia Craft, acquired title to a two-family residence in Brooklyn as tenants-in-common. They each occupied a portion of the ground floor unit while renting out the second apartment. However, when Julia Craft married the appellant, Myers, in 1974, she moved out of the apartment, leaving the respondent, Bartholomew, as its lone occupant. Bartholomew resided in the apartment until his death in 1979. Consequently, title to his undivided one-half interest in the house passed by intestacy to the respondents. Soon after Mr. Bartholomew's death, the appellant and his wife, Julia Craft, moved into the ground floor of the residence. They lived there together until the death of Julia Craft in January 1980. As a result, title to Craft's undivided one-half interest passed by intestacy to the appellant as a tenant-in-common.

The appellant asserted that during the 13-year period since Craft's death, he had continued to reside in the apartment, had been in exclusive possession of the house, had paid all expenses associated with the house, and had collected rent from tenants who had occupied the second apartment.

Finally, on July 1993, Myers, the appellant, brought an action to establish his title by adverse possession. The trial court denied Myers' unopposed motion for summary judgment, holding that under section 541 of the RPAPL, a claim of adverse possession required 20 years of exclusive possession. The Appellate Division, Second Department, modified, awarding summary judgment to the respondents following the same rationale articulated by the trial court. The Court of Appeals granted Myers leave to appeal.

Issue: In the absence of ouster of a non-possessory co-tenant, must a tenant-in-common exclusively possess the property for 10 years or for 20 years before acquiring full title by adverse possession under RPAPL section 541?

Analysis: In affirming the Appellate Division decision, the Court of Appeals refused to acknowledge the appellant's view that a co-tenant's ten-year period of exclusive possession could run concurrently with the ten-year statute of limitations period applicable to adverse possession claims.[2]

The court began its analysis by examining the common law history that led to the enactment of RPAPL section 541. In New York, non-possessory co-tenants were protected from adverse possession claims brought by their co-tenants due to the common law presumption that possession by a co-tenant was possession by and for the benefit of all other co-tenants.[3] As a result, to assert a successful claim of adverse possession under the common law, a tenant-in-common was required to commit acts constituting actual ouster beyond a mere showing of possession. Actual ouster usually required a showing by the possessing co-tenant to express an intention to exclude or deny the rights of co-tenants.

However, the court also noted that under the common law, implied ouster existed in cases where the acts of the possessing co-tenant were so openly hostile that the non-possessing co-tenant was presumed to know that the property was being adversely possessed against them.[4] Thus, under the common law, determining whether there had been an implied ouster was never easily ascertained.

Therefore, the court determined the legislative intent behind the enactment of the Civil Practice Act (CPA) section 41-a, later codified as RPAPL section 541, was to address the inconsistent application of the common law principle of implied ouster. In effect, the court recognized that RPAPL section 541 was "intended to inject clarity into the common law by creating a firm statutory period after which the presumption of non-adverse possession would terminate."[5] The statute follows the common law presumption of possession by one co-tenant is possession by all. However, the statute limits this to a ten-year period of exclusive possession by a co-tenant, after which the presumption of non-adverse possession terminates.Despite the clear legislative intent that led to the enactment of RPAPL section 541, the court found inconsistency between interpretation of the statute and its application by the courts. Specifically, the court focused on the question of when the period of adverse possession begins to run against a non-possessory co-tenant under section 541.

With respect to this issue, the Appellate Division, Third Department has held that a factual showing of adverse possession can rebut the ten-year presumption specified in section 541 that possession by one co-tenant is the possession of all co-tenants. Therefore, under this view, a co-tenant's ten-year period of exclusive possession may run concurrently with the ten-year statute of limitations period required for adverse possession claims.[6]

Alternatively, the Second Department has held that the ten-year presumption is not rebuttable, unless there had been actual ouster. Thus, under this view, absent ouster, a co-tenant's exclusive possession may be considered adverse only after the co-tenant had been in exclusive possession for ten years. Consequently, the Second Department held that the statutory presumption creates a 20-year holding requirement.[7]

The court found the appellant's reliance on the Third Department's interpretation of RPAPL section 541 to be misplaced. The court reasoned that because of the statute's clear language, especially when read in light of its history, the Second Department's interpretation of section 541 was the correct one. Despite this finding, the court proceeded to further examine the legislative history in order to dispel any doubts concerning the proper interpretation of section 541.

Civil Practice Act section 41-a was adopted by the state Legislature in 1949. The court noted that section 41-a "sought to minimize the uncertainty of title plaguing possessory tenants-in-common who had adversely possessed for many years, while also preserving the presumption of non-adverse possession that had been created to protect non-possessory co-tenants."[8] The statute provided for an alternative to ouster, to terminate this presumption—specifically, 15 years of continuous and exclusive occupancy by the possessory co-tenant.[9] However, the 15-year presumption was intended to run consecutively to the period required for adverse possession claims. Civil Practice Act section 41-a was later re-codified as RPAPL section 541, reducing the original presumption period of non-adverse possession to ten years, but was otherwise identical to CPA section 41-a.[10]

The court further noted that, after its enactment, several New York courts misinterpreted and misapplied RPAPL section 541. As a result, the Legislature amended the statute in 1975.[11] The Second Department reasoned that the new statutory language was intended to make clear that the adverse possession period could not begin to run until a co-tenant had exclusive possession for ten years. The court, in arriving at its conclusion, relied on the bill jacket accompanying the 1975 amendment, which identified cases adopting the Third Department's interpretation of the statute as "erroneous decisions."[12]

Finally, the court stated that "holding R.P.A.P.L. §541 to create merely a rebuttable presumption, would be to obliterate the very purpose of establishing the presumption, which was to give tenants-in-common an extra measure of protection against claims of adverse possession by their co-tenants."[13] Therefore, under RPAPL section 541, in the absence of ouster, a tenant-in-common in exclusive possession must possess for 20 years before acquiring full title by adverse possession.

Endnotes

1. N.Y. Real Prop. Acts. § 541 (McKinney 1975) ("Where the relation of tenants in common has existed between any persons, the occupancy of one tenant, personally or by his servant or by his tenant, is deemed to have been the possession of the other, notwithstanding that the tenant so occupying the premises has acquired another title or has claimed to hold adversely to the other. But this presumption shall cease after the expiration of ten years of continuous exclusive occupancy by such tenant, personally or by his servant or by his tenant, or immediately upon an ouster by one tenant of the other and such occupying tenant may then commence to hold adversely to his co-tenant.").
2. *Myers v. Bartholomew*, 91 N.Y.2d 630, 632, 697 N.E.2d 160, 161, 674 N.Y.S.2d 259, 260 (1998).
3. *Florence v. Hopkins*, 46 N.Y. 182, 186 (1871).
4. *Myers*, 91 N.Y.2d 633, 697 N.E.2d 161, 674 N.Y.S.2d 260.
5. *Id.* at 634; 697 N.E.2d 162, 674 N.Y.S.2d 261.
6. *Id. See, e.g., Article Ten Properties, Ltd v. Kocak*, 164 A.D.2d 448, 564 N.Y.S.2d 558 (3d Dep't 1990); *Porter v. Marx*, 179 A.D.2d 962, 579 N.Y.S.2d 219 (3d Dep't 1992).
7. *See, e.g., Kolb v. Anisis*, 104 A.D.2d 399, 478 N.Y.S.2d 720 (2d Dep't 1984).
8. *Myers*, 91 N.Y.2d 635, 697 N.E.2d 163, 674 N.Y.S.2d 262.
9. See *id.*
10. *Id.* 636, 697 N.E.2d 163, 674 N.Y.S.2d 262.
11. *Id.* at 637, 697 N.E.2d 164, 674 N.Y.S.2d 263.
12. *See, e.g.,* Memo of the Comm. on State Legislation of the Bar Association of the City of New York, Bill Jacket, L 1975, ch. 375.
13. *Myers*, 91 N.Y.2d 637, 697 N.E.2d 164, 674 N.Y.S.2d at 263.

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Zoning Regulation of "Adult" Establishments: Constitutionally valid enactment under state's powers to protect the health, safety, and welfare of its citizens.

Stringfellow's of New York, Ltd. v. City of New York and Times Square Business Improvement District, et al; Amsterdam Video Inc. v. City of New York and Times Square Business Improvement District; Rachel Hickerson, et al v. City of New York and Times Square Business Improvement District.

Facts: This was a consolidated appeal brought by adult entertainment establishments ("adult establishments"), "commercial enterprises which 'regularly feature' or devote a 'substantial portion' of stock-in-trade to entertainment or material' which emphasizes 'specified anatomical areas or specified sexual activities,'"[1] and their patrons, who argued that certain amendments to the New York City Zoning Resolution deprived them of their freedom of expression. Under the pre-amendment zoning resolution, all businesses, including adult establishments, were required to satisfy zoning requirements for the "use group in which they were classified."[2] However, this changed with the amendments, which subjected adult establishments to site limitations and anti-clustering provisions.[3]

Specifically, the amendments prevent adult establishments from operating in areas that permit residential uses.[4] To satisfy the new zoning requirements, adult establishments must be located at least 500 feet from schools, houses of worship, day care centers, other adult use facilities, and zoning districts where new residences are permitted.[5] Additionally, no more than one adult establishment, which cannot exceed 10,000 square feet of floor area and cellar space, may be located on a particular zoning lot.[6]

Any adult establishment operating in a prohibited location must either conform or terminate its business within one year of the amendment's effective date.[7] However, the amendments allow a number of narrow exceptions to the termination requirement.[8] For example, adult establishments facing termination are entitled to apply for an extension from the Board of Standards and Appeals, which may permit them to remain open for a limited time to amortize "substantial and unrecovered costs associated with the adult portion of the establishment."[9]

The City Council utilized several studies to determine the impact that adult establishments had on urban life.[10] Based on these studies, the council found that adult establishments had a significant adverse impact on urban life, including an increased crime rate, lower property values, commercial disinvestment, and a decline in economic and pedestrian activity in their surrounding neighborhoods.[11]

The action was commenced in the Supreme Court of New York, which granted defendants' summary judgment motions and held that the amendments did not violate plaintiffs' freedom of expression under either federal or state constitutional provisions.[12] Plaintiff-appellants then appealed to the Appellate Division, which affirmed the lower court ruling.[13] The Court of Appeals heard the final appeal.

Issue: Whether a zoning resolution that restricts the areas in which adult establishments may operate violates federal and New York state constitutional guarantees of free expression.

Analysis: "[L]and use regulations, [as well as all legislative enactments,] enjoy a strong presumption of constitutionality as valid exercises of the State's police power to advance the public, health, safety and welfare" of its citizens.[14] However, since these amendments implicate speech and conduct that is protected by the First Amendment and by the State Constitution, the court balanced the value of free expression with the state's power to advance the public's health, safety, and welfare.[15]

In analyzing the First Amendment claim, the court first determined that the predominant purpose of the amendments was to ameliorate the effects that adult establishments have on urban life, and not to suppress speech.[16] Similarly, under state constitutional analysis, the amendments were not a purposeful attempt to regulate speech.[17] The court found that the extensive history of the amendment demonstrated that the city's only goal was to ameliorate the negative effects on urban life caused by adult establishments.[18]

In so finding, the court rejected appellants' arguments that the evidence was not sufficient to suggest negative secondary effects.[19] Though the studies were based on anecdotal evidence, the court found this type of evidence to be "as telling as statistical data" and that it serves as a "legitimate basis for the finding of negative secondary effects."[20] The court also rejected appellants' argument concerning certain statements by individual council members claiming that the purpose of the amendments was to suppress speech.[21] The court found that these statements were unpersuasive because the motive of the entire legislative body controls legislative intent; therefore, statements of individual council members were irrelevant.[22]

The court then focused its inquiry on whether the amendments were no broader than necessary to achieve their purpose and found that the regulation satisfied both state and federal constitutional analyses.[23] The court stated that the amendments were a well-reasoned attempt at eradicating the negative effects of adult establishments.[24] The court reasoned that "[b]y preventing adult businesses from locating in residential districts while allowing such establishments to locate in manufacturing and commercial districts, the amendments protect only those communities and community institutions that are most vulnerable to their adverse impacts."[25]

The court then determined that reasonable alternative avenues existed for the relocation of adult establishments.[26] Appellants relied heavily on an affidavit by a land use planning and local government consultant.[27] The consultant alleged that most of the sites claimed by the government to be available were actually unavailable because they are occupied by long-term tenants and are "unlikely to yield new tenants."[28] The court stated that the affidavit did not raise a triable question of fact because several of the premises relied on by it are inconsistent with controlling legal principles.[29]

Under controlling principles, "land that is already occupied by commercial and manufacturing facilities and undeveloped land that is not for sale or lease is not to be deemed unavailable" for purposes of this analysis.[30] The proper inquiry is whether land in all stages of development is physically and legally available for use within the city's borders and whether those sites are part of an actual real estate market.[31] The court held that since 11 percent of the city's total land mass was available to adult establishments, there were reasonable alternative avenues available.[32]

The court stated that the most significant flaw with the appellants' argument was the lack of any "attempt to quantify his observations or to make concrete allegations as to precisely how many of the 500 potential receptor sites identified by the appellants were, in his estimate, unavailable.[33] Thus, the court found it impossible to determine whether the 177 adult establishments that have to relocate can be accomodated by the number of available sites.[34] Therefore, the court did not seriously question the accuracy of the city's calculations of available sites.[35] Thus, based on these facts, the court determined that reasonable alternative avenues existed.[36]

The court also rejected appellants' argument that the enforcement of the amendments constitutes an unconstitutional taking in violation of the due process clause.[37] The court reasoned that since adult establishments can apply to the city's Board of Standards for permission to operate if they have spent substantial amounts of money to remedy the nonconformity.[38] Thus, the appellants could not argue a violation of their due process rights unless they avail themselves of this process.[39] For the foregoing reasons, the court affirmed.

Endnotes

1. Amended Zoning Resolution § 12-10 (Oct. 25, 1995).
2. *Stringfellow's of New York, et al v. City of New York, et al,* 694 N.E.2d 407, 412 (N.Y. 1998).
3. *Id.* at 413.
4. Amended Zoning Resolution § 32-01 (a) (Oct. 25, 1995).
5. *Id.*, § 32-01 (b).
6. *Id.*, § 32-01 (d), (e).
7. *Stringfellow's,* 694 N.E.2d 413.
8. *Id.*
9. *Id.* (citing Amended Zoning Resolution § 72-40).
10. *Id.* at 415.
11. *Id.* at 411-12.
12. *Id.* at 413.
13. *Id.*
14. *Id.* at 413-14.
15. *Id.* at 415.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at 416.
20. *Id.* at 417.
21. *Id.* at 416.
22. *Id.*
23. *Id.* at 418.
24. *Id.* at 417.
25. *Id.*
26. *Id.* at 419.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.* at 418.
31. *Id.*
32. *Id.* at 418-19.
33. *Id.* at 419.
34. *Id.*
35. *Id.*
36. *Id.* at 419-20.
37. *Id.* at 420.
38. *Id.*
39. *Id.*

Steven Madra '00

* * *

Assignment Limitation Language: Landlords may find that the use or purpose clause of a lease will not serve as sufficient basis for withholding consent to an assignment or a sublease. *International Chefs Inc. v. Corporate Property Investors*, 240 A.D.2d 369 (1997).

The Appellate Division, Second Department held that the landlord did not possess unfettered discretion to withhold consent to assignment of a lease to a prospective tenant that was not engaged in the exact same business as the tenant.

The defendant, Corporate Property Investors (CPI), had leased space in the shopping center's food court to the plaintiff, International Chefs Inc., restricting its use to the sale of seafood and desserts. Three years into the lease, plaintiff sought to assign to Kabuki New Jersey, a company that proposed using the premises for the sale of Japanese food. While the lease contemplated assignment, it required the written consent of CPI, and further provided that consent could not be "unreasonably withheld."

CPI denied approval, explaining that Kabuki would compete with an existing Japanese restaurant. The plaintiff commenced this action claiming that CPI had unreasonably withheld consent to the proposed assignment. CPI sought and was denied summary judgment. The Appellate Division held that an issue of fact existed as to whether it had unreasonably withheld its consent to the proposed assignment.

Analysis: On appeal, CPI argued that it possessed unfettered discretion to withhold consent to an assignment where the proposed tenant is not engaged in the exact same business as the existing tenant. The Appellate Division disagreed, holding that the reasonableness of the refusal is a question of fact. In so determining, the Appellate Division looked to the lease as a whole, and found that the assignment provision of the lease expressly indicated that in determining the reasonableness of a proposed assignment, CPI may take into account the nature of the business of the proposed assignee. This and other provisions would be rendered superfluous if the defendant's interpretation of the assignment provisions prevailed. Thus, the Appellate Division affirmed the Supreme Court's holding.

Astoria Bedding, Mr. Sleeper Bedding Center Inc., v. Northside Partnership, 239 A.D.2d 775 (1997).

The Appellate Division, Second Department held that the landlord's sole reliance on lease's purpose clause as justification for withholding consent to sublease was not reasonable.

Plaintiff, Astoria Bedding, was party to a ten-year commercial lease which provided that it would use the leased premises "only" for the purpose of conducting and operating a retail bedding, home furnishings and accessory business. The lease also provided the tenant the right to sublet subject to the written approval, which would "not be unreasonably withheld."

The plaintiff sought and was refused landlords' consent to a sublease to Lake Group Ltd., the operator of a packaging and mailing service. The defendant refused to consent on the ground that Lake Group's proposed use of the premises did not conform to the use permitted under the lease. Plaintiff brought an action seeking declaratory judgment that defendant's denial of consent was unreasonable. Both parties moved for summary judgment. The Supreme Court granted the defendant's summary judgment motion, finding that the word "only" in the purpose clause indicated that the parties intended that the use of the premises be limited to a retail bedding establishment. The plaintiff appealed.

The Appellate Division explained that while landlords' use provisions will be given effect in a lease, the use provisions will not be given equal effect in covenants that seek to limit the right to assign or sublet. The latter do not comport with the notion of free alienability of land. Therefore, use and consent provisions are narrowly construed. Moreover, the court explained that where a landlord promises not to unreasonably withhold its consent, its refusal can only be based upon a consideration of objective factors.

Thus, in the instant case, defendant's sole reliance on the purpose clause of the lease as its justification for withholding consent cannot be deemed reasonable as a matter of law. The court explained that the sublet provisions did not expressly limit the plaintiffs' right to sublet to those engaged in the retail bedding business. Furthermore, the sublet provision did not incorporate the purpose clause. The Appellate Division found that the defendant was not entitled to summary judgment.

Lori S. Hatem '99

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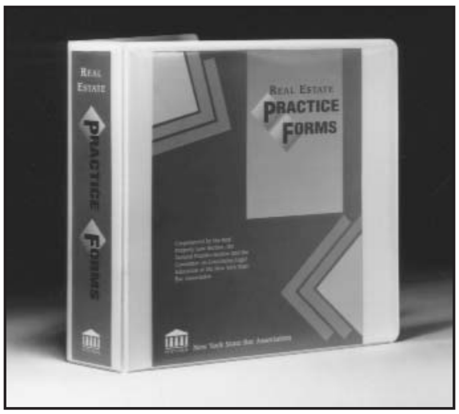

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REAL ESTATE PRACTICE FORMS is a loose-leaf and diskette collection of forms and other materials used by experienced real estate practitioners in their daily practices. REAL ESTATE PRACTICE FORMS are invaluable to the new practitioner or non-real estate expert, as well as the experienced practitioner who may find a preferred form or an addendum for a novel contract situation.

This collection of forms includes closing checklists; deeds; residential contracts of sale, along with numerous riders and addendums; an array of documents relating to titles and surveys; and much more. Variations of some forms (e.g., closing statements) are provided for added flexibility.

Many of the practice forms are drawn from the materials provided by expert lecturers at our continuing legal education seminars. The forms and other materials are formatted for use in Microsoft Word and WordPerfect, and they can be readily adapted to meet individual practitioners' needs.

Sponsored by the Real Property and General Practice Sections, and edited by Keith Osber, Esq., of Hinman Howard & Kattell, REAL ESTATE PRACTICE FORMS will assist in handling every step of a standard residential real estate transaction.

Cosponsored by the Real Property and General Practice Sections and the Committee on Continuing Legal Education of the New York State Bar Association.

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