

## **RECENT DEVELOPMENTS: A PANEL OF LAW PROFESSORS**

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Gregory M. Stein is the Woolf, McClane, Bright, Allen & Carpenter Professor of Law at the University of Tennessee College of Law, where he has been a member of the faculty since 1990. He teaches the basic Property course, along with advanced courses in real estate finance, real estate development, and land use. Professor Stein's recent publications include the book *A Practical Guide to Commercial Real Estate Transactions* (ABA 2001; co-author); the chapter *The House That Ruth Built* in *Courting the Yankees: Legal Essays on the Bronx Bombers* (Carolina Academic Press 2003); the chapter *The Effect of Palazzolo v. Rhode Island on the Role of Reasonable Investment-Backed Expectations* in *Taking Sides on Takings Issues: Public and Private Perspectives* (ABA 2002), and the article *Takings in the 21<sup>st</sup> Century: Reasonable Investment-Backed Expectations after Palazzolo and Tahoe-Sierra*, 69 Tenn. L. Rev. 891 (2002). He served as the Visiting Fulbright Professor of Law at Shanghai Jiaotong University Law School in Shanghai, China during the spring of 2003.

Frederic White is Dean at Golden Gate University School of Law, San Francisco, California. Prior to coming to Golden Gate he served as Professor of Law at Cleveland-Marshall College of Law, Cleveland Marshall College of Law, where he taught Property, Estates and Trusts, Land Use Control and Real Estate Transactions. He received his B.A. degree from Columbia College and his J.D. degree from the Columbia University School of Law. He is licensed to practice law in Ohio, and is a member of the American, Ohio State and Norman S. Minor bar associations. In addition to teaching, Dean White served as the principal instructor for the Northeast Ohio Apartment Association. He served as a mediator, instructor and consultant for the Housing Division of the Cleveland Municipal Court. Dean White is a former member of the Ohio State Bar Association Real Estate Practice Certification Board Committee. He is also the author of *Ohio Landlord Tenant Law*, published annually by Thomson West. His most recent law review is entitled, "*Outing the Madman: Fair Housing for the Mentally Handicapped and their Right to Privacy versus the Landlord's Duty to Warn and Protect*," XXVIII Fordham Urban Law Journal 783 (2001).

**1. If an owner knowingly constructs a building that violates a restrictive covenant in the face of objections from a neighbor who is a party to that covenant, is it appropriate for the court to order the owner to remove the offending structure? The Kentucky Court of Appeals gives a firm “Yes,” and orders Home Depot to tear down these walls.** *Home Depot, U.S.A., Inc. v. Saul Subsidiary I Limited Partnership*, \_\_\_ S.W.3d \_\_\_, 2004 WL 1699614 (Ky. App. 2004).

Home Depot and Saul Subsidiary I owned adjoining parcels of land in Lexington, Kentucky. Their predecessors in title had entered into a restrictive covenant that, while recognizing that the neighboring properties would be “separately developed,” mandated that the owners construct “one (1) mall-type shopping center, compatibly designed.” The original owners built a conforming mall in the 1970s, which later fell on hard times. Despite the language of the covenants, Home Depot announced its intention to build a free-standing store on one of the two parcels just before it acquired the land. Even after Saul sought an injunction, Home Depot bought the land, demolished the part of the mall that was still standing there, and constructed a free-standing store.

The trial court refused to issue the injunction and ultimately held that Home Depot had not violated the covenants. The Kentucky Court of Appeals reversed and remanded for a determination of the proper remedy. On remand (and after the recusal of the original trial judge), the trial court found that Home Depot “had made a deliberate business decision to proceed with its project while the original appeal was pending,” even though it was fully aware of the risk. Given that Saul’s monetary damages could not reasonably be calculated, the trial court ordered Home Depot to remove the new structure and replace the original one within one year. Home Depot appealed.

The Court of Appeals affirmed, sharply rebuking Home Depot in the process. The opinion suggests that Home Depot had conceded liability and quarreled only with the injunctive remedy. But the court would have none of it, finding that Home Depot had injured itself by making a poor business decision, and concluding, on the basis of a 1969 opinion from the state supreme court, that an injunction is no different from an award of specific performance. The court’s summarized Home Depot’s actions in one terse sentence: “Home Depot’s predecessor in title entered into the 1969 agreement; Home Depot acknowledged its existence, as well as the existence of the covenants; Home Depot violated those covenants.”

Lawyers for developers need to remember the lessons they learned in their first-year Property course. Covenants and servitudes (and by enforcing this agreement by injunction, the court presumably was treating it as an equitable servitude) mean what they say, and if an owner does not get permission, they should not assume the court will grant forgiveness. It is tough to imagine what Home Depot’s lawyers, and the lawyers for any mortgage lender, were thinking, both in their reading of the document and in their continuation of construction in the face of opposition from Saul.

**2. If a city modifies the boundaries of a street and then takes no subsequent action to use the excess property or formally dedicate it to public use, has the city converted its ownership from “governmental” to “proprietary,” thereby subjecting itself to adverse possession claims by others? The New York Supreme Court, Appellate Division, answers “Yes.” *Albany Parking Services, Inc. v. City of Albany*, 770 N.Y.S.2d 472 (App. Div. 2004).**

Charles Hebert Sr. obtained title to several adjoining lots in Albany, New York, on which he operated a commercial parking lot. In most cases, he acquired his title by deed, but he believed he had adversely possessed one parcel between 1940 and 1982. Hebert’s daughter, Justine Fuller, continued to claim an interest in the adversely possessed land, but the record title holder, the city of Albany, claimed that it continued to own the land in its governmental capacity as part of a public street. The city asserted its claim in court, and Fuller moved for summary judgment, arguing that the city had abandoned its interest in the land back in 1911, when it decided to exclude the land from Spruce Street. Thus, Fuller argued, the city had thereafter owned the land in a proprietary capacity and not a governmental capacity, which would allow Hebert to adversely possess the land. The city did not dispute that Hebert had otherwise met the elements of adverse possession. The trial court granted Fuller’s motion; the city appealed.

The Appellate Division of the Supreme Court agreed that title to the disputed area turned on whether the city had owned the land “in a governmental capacity, which would make it immune to adverse possession, or in a proprietary capacity, which would not protect it.” The answer to this question could be found in the city’s actions beginning back in 1911, when the city council set a new boundary for the street, thereby closing that portion of the street currently in controversy. Even if this boundary change by itself not did transform the city’s ownership from governmental to proprietary, the city took no action after that time either to dedicate the property to any other public use or to use it for any other public purpose. And from 1947 to 1982, Hebert had exclusive use and control of the property.

The opinion is unclear as to when the city took or failed to take the action that converted its ownership to proprietary status. Although the court focuses on the 1911 change in boundary, it also notes that the city took no subsequent action showing “governmental” status, implying that post-1911 acts might have served to re-characterize the city’s prior inaction. Moreover, Hebert’s exclusive use and possession for 35 years are used to show lack of governmental purpose, but the real issue is whether the city was subject to adverse possession in the first place, no matter how clearly Hebert had met those elements. In short, if meeting the elements is evidence that the government owned the land in a proprietary capacity, then the government would appear to be subject to adverse possession in the same manner as any private citizen. Perhaps the best lesson of the case is that government bodies and their lawyers must clarify the capacity in which the government holds its land. The court’s opinion suggests that a specific statement by the city in 1911, and possibly even as late as the 1950s or 1960s, would have been enough to prevent Hebert from acquiring title.

**3. May any resident of a state enforce a conservation easement? The Tennessee Court of Appeals, interpreting state legislation, holds “Yes.”** *Tennessee Environmental Council, Inc. v. Bright Par 3 Assoc., L.P.*, 2004 WL 419720 (Tenn. App. 2004).

In 1996, the East Ridge Development Co. conveyed a conservation easement to the city of Chattanooga affecting land adjacent to Chickamauga Creek. The defendants own and developed some property zoned for business purposes located adjacent to the easement. Two organizations and an individual plaintiff, Sandy Kurtz, alleged that the defendants’ activities adversely affected the easement. The trial court dismissed the complaint because the plaintiffs had no standing to enforce the easement. The trial court determined that Kurtz had to demonstrate that she had suffered “injury separate and apart from that of [a] member of the public,” that her strong interest in environmental issues was insufficient to make this showing, and that only the city had standing to enforce the easement. The trial court relied heavily on the language of the grant, concluding that only the city, which was designated as the easement’s grantee, had standing to enforce it.

On appeal, the Tennessee Court of Appeals examined several sections from the state’s Conservation Easement Act. In particular, the court focused on section 66-9-307 of the Tennessee Code Annotated, which provides that “conservation easements may be enforced . . . by the holders and/or beneficiaries of the easement, or their bona fide representatives, heirs, or assigns.” The appeals court concluded that the legislature’s inclusion of the words “and/or beneficiaries” indicated a clear intent to create rights in parties other than the grantee, notwithstanding any language to the contrary in an individual grant. And since section 66-9-303 states that conservation easements are “held for the benefit of the people of Tennessee,” then the beneficiaries of the easement who have standing to enforce it include any state resident. The court therefore remanded the case, expressing no view on the merits or on any appropriate remedies if the plaintiffs prevail.

The court noted that several other states, but not Tennessee, have adopted the Uniform Conservation Easement Act, under which third parties may not enforce conservation easements unless the easement itself expressly grants that right, and that Tennessee appears to be the first state to grant enforcement powers to “beneficiaries” of the easement. Thus, in Tennessee, the words of the legislature trump any restrictive language in the grant, while in Uniform Act states, third parties possess enforcement rights only if the easement so states. Lawyers in other states need to familiarize themselves with the laws of their own state and to draft their way around default rules to which their clients object, unless these rules cannot be avoided.

**4. If a town grants a development permit on the condition that the landowners record a conservation restriction that closely tracks the town’s existing environmental regulations and that does not limit the owners’ right to exclude others from the property, has the town taken the owners’ land? A closely divided New York Court of Appeals rules “No.” *Smith v. Town of Mendon*, \_\_\_ N.E.2d \_\_\_, 2004 WL 2941271 (N.Y. 2004).**

The Smiths own a 9.7 acre lot in Mendon, portions of which fall within four different environmental protection overlay districts, or “EPODs.” In 2001, the Smiths sought site plan approval to build a single-family home on a portion of the land not located in any of the EPODs. The town’s planning board granted its approval on the condition that the Smiths record a conservation restriction prohibiting development within the EPOD areas. Although the restriction the board demanded would closely track the EPOD limitations themselves, and the Smiths would retain the right to exclude others from the entire parcel, the board acted so that the land records would place subsequent buyers on notice of the restriction.

The Smiths rejected the board’s condition and sought declaratory relief, arguing that the requirement took their property. The trial court applied the restrictive exaction test announced in the U.S. Supreme Court’s *Nollan v. California Coastal Commission* and *Dolan v. City of Tigard*, concluding that the restriction was an exaction, but found that the town had met the heightened scrutiny test of *Nollan* and *Dolan* and had not taken the Smiths’ property unconstitutionally. The Smiths appealed, and the Appellate Division affirmed, concluding that the restriction did not even amount to an exaction. The landowners then appealed to the Court of Appeals.

The Smiths continued to maintain that the board’s actions were an exaction, subject to the high level of scrutiny required by *Nollan* and *Dolan*. The court, however, agreed with the town’s argument that an exaction occurs only when a government body conditions its approval of development on an owner’s dedication of its land to public use, citing the Supreme Court’s later decision in *City of Monterey v. Del Monte Dunes at Monterey, Ltd.* In the instant case, the owner was not required to dedicate its property to public use; rather, the town was imposing a “do-no-harm” restriction to protect environmentally sensitive land. Significantly, the Smiths retained the right to exclude others from all parts of their land. Moreover, the limitations to be included in the conservation restriction went little further than the similar restrictions already included in the town’s EPOD regulations. The state court found no reason under state law to expand the exaction rule to situations beyond those covered by the Supreme Court’s jurisprudence.

Because the *Nollan/Dolan* test did not apply, the New York court evaluated the Smiths’ claims under the standards of *Agins v. Tiburon* and *Penn Central Transportation Co. v. City of New York*. Under the more relaxed standards laid out in these cases, the town’s actions did not amount to a taking.

Three judges dissented. Two of them argued that the town was attempting to exact property, thereby triggering the *Nollan/Dolan* standard, and that the town had violated this standard and taken the Smiths’ land. These justices believed that a permit condition can constitute an exaction even if it does not infringe on the owner’s right to exclude. To these judges, only outright denials are immune from the *Nollan/Dolan* test; any other condition must meet this higher level of scrutiny. A third judge would have found a taking even under the standard articulated in *Agins*.

The court’s opinion seems correct under the *Del Monte* rule, but this 4-3 split on a politically moderate state high court suggests just how close the question is. Attorneys representing municipal bodies need to be aware that this issue still is unsettled: The boundary line between the tougher standard imposed on exactions and the gentler rules applicable in other settings remains unclear. Given how little the town stood to gain here, the imposition of the condition may not have been worth the risk.

**5. If a wind insurance policy specifically excludes coverage for flood damage, but a statute expressly states that any insurer providing coverage as to a covered peril is liable up to the face amount of the policy following a total loss, must the wind insurer pay the face amount of the policy following a storm in which wind damage caused 57% of the loss? The Florida District Court of Appeal says “Yes.”** *Mierzwa v. Florida Windstorm Underwriting Assoc.*, 877 So. 2d 774 (Fla. App. 2004).

Zennon Mierzwa, a Florida homeowner, suffered severe property damage due to Hurricane Irene. Local authorities condemned his home after finding that the cost of repairs exceeded half the value of the building, an action permitted under a Fort Lauderdale ordinance that would require Mierzwa to rebuild under current, stricter building codes. Mierzwa insured his home for wind damage with Florida Windstorm Underwriting Association (FWUA) and for flood damage with another carrier. The wind insurer’s policy excluded coverage for any other type of damage (and expressly mentioned flood damage), but Florida’s Valued Policy Law requires any responsible insurer to pay the face amount of its policy following a total loss. The wind insurer argued that it should be liable only for that portion of the damage attributable to wind damage, and not for either flood damage or the additional costs resulting from the city’s condemnation of the remainder of the structure under its ordinance. The trial court agreed with FWUA, and Mierzwa appealed.

FWUA relied on the anti-concurrent cause clause (ACCC) in the policy, noting that flood damage, constituting 43% of the loss, was specifically excluded from coverage under the wind insurance policy. The Florida District Court of Appeal rejected this argument for two reasons. The first reason focuses on the interaction between the ACCC in the policy and the state’s VPL. The VPL unquestionably states that if an insurer has provided insurance for a covered peril, the insurer’s liability for a total loss is in the face amount of the policy. At the same time, the policy’s ACCC unquestionably states that FWUA’s liability shall be calculated without consideration of flood damage. However, the policy does not expressly state that the ACCC overrides the VPL; rather, the policy holder’s coverage is governed by the contradictory language in the policy and in the statute. The court resolved this ambiguity by following the interpretation that provides greater indemnity, as required by state precedent.

The court’s second reason for rejecting the insurer’s argument arises from the operation of the Fort Lauderdale ordinance requiring Mierzwa to meet current building codes following a loss of more than 50%. The insurer failed to show that the wind damage alone did not trigger the working of this statute. Thus, even in the absence of any flood damage at all, the wind damage might have triggered the city ordinance on its own, resulting in a total loss to Mierzwa.

The intermediate court went out of its way to avoid answering some important questions. Chief among them is the effect of language in an insurance policy stating expressly that the ACCC overrides the VPL. The court notes, however, that this addition would require approval by the state agency regulating insurance, perhaps implying that if it is okay with the regulators, it will be okay with the court.

Other open issues: The wind damage to Mierzwa's house was apparently 57% of the total damage, before the city ordinance kicked in. But what if Mierzwa had suffered only one dollar of wind damage? The court punts on this "parade of horrors" issue in a footnote, and a concurring judge emphasizes this concern, but the underlying theme of the whole opinion is that the insurer can read the VPL and price its policies accordingly, factoring in risks such as this one. Can Mierzwa now recover 100% from his flood insurer? The court does not specifically raise this question, but it does quote from a somewhat distinguishable intermediate court case, *Millers' Mutual Insurance Association v. La Pota*, suggesting that the answer is "yes." As one of the judges notes in a concurring opinion, if an insurer (or, presumably, a group of insurers) thinks it can profit by selling a homeowner more insurance than he needs and then disclaiming excess liability following a total loss, it needs to do some re-thinking. And even if Mierzwa does not proceed against his flood insurer, is FWUA entitled to contribution from the flood insurer after it pays Mierzwa the full face amount of the wind insurance policy? That was not the issue here, the court observes in a footnote, but one assumes the answer must be "yes." (A concurring judge would hold "that FWUA is entitled to a credit for any damages attributable to flood," but fails to elaborate further.)

The morals of the case for the insurance industry seem to be: (1) watch what you say in your policies, because the courts will not construe them in your favor; and (2) be aware of all risks arising under the policy and state law, and charge premiums accordingly. I would bet heavily that the insurance industry will attempt to respond through the courts, the legislature, and the state regulatory body. And I personally know of one Panhandle victim of Hurricane Ivan who is suing his wind insurer in faraway Miami, because Miami is located in the judicial district that decided *Mierzwa*.

Given the terrible season Floridians suffered in 2004 and the certainty of future storms, this case is an incredibly important one. It addresses an extremely interesting issue, but—like insurance policies themselves—is not an easy read. Every real estate lawyer faces insurance issues regularly, whether advising clients on the front end of transactions or representing them following a covered loss. *Mierzwa* is a reminder that we need to pay careful attention to the language of both the applicable insurance policies and any relevant state laws.

**6. If a restrictive covenant allows a two-thirds supermajority to amend the covenant, can such a supermajority impose non-uniform amendments? The Michigan Court of Appeals says “No,” holding that non-uniform amendments require the unanimous consent of affected property owners. *Maatta v. Dead River Campers, Inc.*, 689 N.W.2d 491 (Mich. App. 2004).**

Defendant Dead River Campers, Inc., bought several thousand acres of land in Michigan’s Upper Peninsula, subdivided it into 375 residential lots, and imposed uniform restrictive covenants limiting all lots to residential and incidental recreational purposes. Defendant retained Lot 4 as a public access site to a lake, and equipped this lot with a parking lot, boat launch, and pit toilets. Maatta and several other lot owners sought a permanent injunction against public access to Lot 4, claiming that the current use violated the covenants. Meanwhile, defendant drafted a resolution to exempt Lot 4 from this particular covenant, and the resolution passed by the required two-thirds supermajority. The trial court upheld the validity of the amendment and the plaintiffs appealed to the Michigan Court of Appeals.

The plaintiffs’ principal argument was that the defendant “was not permitted to amend the restrictive covenants to remove restrictions from one lot while leaving them intact for the remaining lots.” Because each owner assumed the burden of complying with these restrictions, each was entitled to the corresponding benefit of compliance by all other owners. Their awareness that the covenant contained an amendment procedure did not undercut their argument, they believed, because the document did not expressly permit non-uniform amendments.

The appeals court performed a moderately thorough survey of other states before reversing the trial court and ruling in favor of the plaintiffs. Quoting extensively from *Walton v. Jaskiewicz*, a Maryland Court of Appeals case, the Michigan court concluded that property owners generally assume mutual uniform enforcement of restrictive covenants. The trial court’s holding might lead to a situation in which shifting 51% majorities (or shifting supermajorities) could exempt their own property from various restrictions, leading to “a patchwork quilt of different restrictions [that] completely upset the orderly plan of the subdivision.” The only way to amend the covenants in a non-uniform fashion is to obtain the unanimous consent of all the affected property owners.

The court adopts a rule that seems fair and in accord with holdings in other states. The rule may lead to certain inefficiencies, with a single unreasonable holdout in a position to block desirable change. But “desirable” is in the nature of the beholder, and holdout problems are inherent in the law of covenants. The court’s holding also leaves open the possibility that a restrictive covenant might authorize non-uniform changes by less than unanimous consent in the original covenant document.

**7. Do property owners have a duty to provide lateral support to artificial additions on a neighbor's property? The Tennessee Supreme Court says "No," holding that the duty of lateral support applies only to the neighboring property in its natural state. However, if an owner removes lateral support to an artificial improvement, it must do so non-negligently. *XI Properties, Inc. v. RaceTrac Petroleum, Inc.*, \_\_\_ S.W.3d \_\_\_, 2004 WL 2903990 (Tenn. 2004).**

Defendant RaceTrac Petroleum owned a parcel of land on which it had constructed a gas station and parking lot. At the time of construction, RaceTrac added fill dirt to level the parking lot and created a sloped embankment to support the sides of the lot. RaceTrac conveyed some vacant land adjacent to the parking lot to plaintiffs, and inadvertently conveyed the embankment to plaintiffs. Plaintiffs began making plans to develop their lot and concluded that they would have to remove a portion of the embankment. They notified RaceTrac of their plans and asked RaceTrac to deal with the proposed alterations. RaceTrac objected, and plaintiffs filed a declaratory judgment action seeking to clarify their property rights.

The trial court concluded that plaintiffs' only duty was to provide lateral support to the land in its natural state and not to provide any additional support necessitated by defendant's improvements to the land. Thus, plaintiffs could excavate the sloped embankment down to the point where it became land in its natural state. The Court of Appeals affirmed, but added that the plaintiffs must excavate the sloped embankment non-negligently.

On appeal to the Tennessee Supreme Court, RaceTrac argued that plaintiffs had purchased the property "as is" and thus were responsible for maintaining lateral support to the improvements as well as to the land in its natural state. RaceTrac also argued that if the court adopted the lower courts' "natural state" rule, it should define "natural state" to mean the state of the land at the time RaceTrac subdivided it and sold part of it to the plaintiffs. After surveying lower court opinions in Tennessee and a large number of cases in other jurisdictions, the state high court affirmed the ruling of the intermediate appellate court in favor of the plaintiffs.

The court held that "land in its natural state is entitled to lateral support from the adjoining land." If a neighbor removes the necessary lateral support for an owner's land in its natural state, the neighbor is strictly liable for damages arising from the removal. However, this rule does not apply to land that has been altered in such a way as to require additional lateral support. In this latter case, the owner does not enjoy a right of lateral support from its neighbor with respect to the alterations. However, if the neighbor has been providing lateral support to improved land, the neighbor must employ reasonable care when it withdraws its lateral support of the artificial additions to the owner's property. Citing Restatement (Second) of Torts, Section 819 and comments e and f, the court noted that factors used to determine "reasonable care" include "the necessity of the excavation; whether adequate notice was given to adjoining landowners; whether reasonable precautions were taken to prevent harm to adjoining property; whether competent workers were employed; and whether proper instrumentalities were used."

The court also concluded that the "natural" condition of the land means conditions that do not in any way result from human activity. Moreover, if the plaintiffs remove the embankment non-negligently, RaceTrac must take affirmative steps to ensure that the parking lot and fill dirt will not collapse onto the plaintiffs' property, such as by building a retaining wall.

If the law is to continue to apply the ancient doctrine of lateral support, then it must establish a baseline state for any land which is to be supported laterally. Choosing the land's natural state is as good a rule as any, and probably better than most. This rule seems to accord with most of the precedent and with the expectations of the parties (which are themselves informed by that precedent). Moreover, RaceTrac's problem here was largely of its own creation, since it conveyed the embankment to plaintiffs in error. Read those surveys!

**8. Hedrick v. Mosser, 591 S.E.2d 191 (W. Va. 2003). Application of an anti-lapse statute results in a substituted gift to the issue of a deceased joint tenant who was specifically devised the jointly held property in the will of the surviving joint tenant.**

Testator and his sister took title to land as joint tenants with right of survivorship in 1961. Eleven years later testator executed a will specifically devising to his sister “my interest in real estate that we own jointly” and leaving the residue of the estate to his sons. Although his sister died in 1990 leaving him sole owner of the property, testator’s will was unchanged at his death four years later. Plaintiffs, described as the sister’s “heirs” (presumably her issue), sought a declaratory judgment that the property passed to them under the anti-lapse statute rather than to testator’s sons under the residuary devise. The Circuit Court ruled in favor of the sons. The Supreme Court of Appeals of West Virginia reversed, finding that it was testator’s intention that “his sister and/or her issue” receive the real estate upon his death. Application of the state’s anti-lapse statute resulted in a substituted gift to the issue of the deceased sister.

This case contains a lesson in basic will-drafting. The scrivener clearly knew that the specifically devised real estate was held “jointly.” If that meant as joint tenants with right of survivorship – as indeed it did – then the will provision was unnecessary. Had testator’s sister outlived him, she would have taken outside the will, by right of survivorship. The specific devise may have been intended as additional security that she would get the property one way or the other, but this belt-and-suspenders approach raised two questions when the testator outlived her. First, was the specifically devised property adeemed, that is, did the gift fail because at testator’s death there was no longer any property in the estate matching the description “real estate that we own jointly”? Second, was the sister’s survival a condition of the gift? If testator had not intended a requirement of survival, he could have said: “to my sister if she survives me, but if she does not survive me, then to her issue.” But in that case, would he have described the property as “my interest in real estate that we own jointly”?

The appellate court recited the oft-repeated rule that “the paramount principle in construing or giving effect to a will is that the intention of the testator prevails,” and believed it was effectuating testator’s intention. But was it? The testator clearly chose his sister over his sons for the specific devise. But would he have chosen his nephews and nieces over his sons? The latter lost when the court accepted that the words “and/or her issue” belonged in the devise to the sister.

**9. Estate of Pickett, 879 So.2d 467 (Miss. App. 2004). Specific devise of real property was adeemed by the execution of a contract of sale even though testator died before closing; the right to the sale price is personal property and passes under the residuary clause.**

Testator's nephew, acting under a power of attorney, executed a contract for the sale of land owned by testator. After the contract but prior to closing, testator died. Purchaser tendered the contract price but no deed was delivered because the power of attorney had terminated at the death of the testator and no personal representative had been appointed. The land subject to the contract of sale was specifically devised by testator's will, and the devisees petitioned to set aside the sale or, in the alternative, to allow it but award them the proceeds. The Chancellor ruled that the purchaser was entitled to specific performance of the contract and, applying traditional ademption doctrine, that the specific devise failed because the subject property was not in the estate at testator's death. Equitable conversion had transformed the legal title to the land into personal property by the time of testator's death and in consequence it passed to the residuary devisees, testator's nieces and nephews – including the nephew who had executed the contract for sale of the land on behalf of the testator. The Mississippi Court of Appeals affirmed.

Under standard ademption law, the question whether a specific devise fails is determined by asking whether the identical property named in the gift is in the estate at testator's death. In the present case, complete legal and equitable title to the devised property was not available after the specifically enforceable contract of sale was executed, so the gift failed. The so-called identity theory has been criticized for its potential to defeat intention, and the latest version of the Uniform Probate Code abandons it in favor of an "intent theory." Had the UPC been in effect in Mississippi, the specific devisees would have prevailed over the residuary devisees. UPC § 2-606 (a) provides that "a specific devisee has a right to the specifically devised property in the testator's estate at death and... any balance of the purchase price... owing from a purchaser to the testator at death by reason of sale of the property..." This result could also be supported by the argument that equitable conversion, which is supposed to be based on the intent of the parties, should not be applied inequitably.

Even traditional ademption doctrine admitted of an exception in case the sale of the specifically devised property was executed by the conservator of an incompetent testator, in which case it could not be assumed that testator intended to alter the effect of the will. Massachusetts decisional law, which adheres to the traditional identity theory and is cited in the Mississippi case, admits this exception. *Walsh v. Gillespie*, 154 N.E.2d 906 (Mass. 1959). In addition, UPC § 2-606 (b) provides that "if the specifically devised property is sold or mortgaged by a conservator or by an agent acting within the authority of a durable power of attorney for an incapacitated principal ..., the specific devisee has the right to a general pecuniary devise equal to the net sale price..." Other than a description of the nephew's power of attorney as "general" and a passing reference to the testator's death as "unanticipated," there is no mention in the opinion of testator's capacity at the time of the contract.

**10. Abernathy v. Adous, -- S.W.3d --, 2004 WL 2345638 (Ark. App. 2004). Equitable relief from forfeiture is not available to subtenants, and whether a particular transfer by a tenant is an assignment or a sublease is a matter of intention.**

Plaintiff landlord leased commercial premises at a fixed rent for a term of ten years with six consecutive five-year options to renew. The lease, which included a right of re-entry in case of a default in rent or the tenant's insolvency, contained no covenant against transfer by the tenant. With approximately five years and nine months remaining on the original term, the tenant executed an instrument captioned a "sublease agreement" with a transferee for a term of five years and eight months with six consecutive five-year options to renew at a rent equal to the rent owed by the tenant. The agreement included a right of re-entry for nonpayment of rent. With a subsequent "addendum to [the] sublease agreement" the tenant added defendant as transferee. Although defendant regularly paid the rent to the tenant, the tenant eventually failed to remit it to the landlord and became insolvent. In response to an action for possession, defendant tendered the rent directly to the landlord who refused to accept it. The trial court, finding that the transfer was an assignment, that the temporary default in rent was not chargeable to defendant, and that defendant had made plaintiff whole, refused to order defendant to surrender possession. The judges of the Arkansas Court of Appeals, dividing 4 to 2, held that whether the transfer was a sublease or an assignment was a matter of intention and found that the parties intended a sublease. The majority also held that equitable relief against forfeiture was limited to assignees and was not available to subtenants. Since the transfer was a sublease, it terminated when the top lease terminated and therefore the landlord was entitled to possession.

The common law test for distinguishing a sublease from an assignment is objective: Has the tenant transferred the entire remaining term? If so, then the transfer is an assignment. If not, then the transfer is a sublease. Since the tenant had reserved the final month of the term, application of the common law test would have resulted in the characterization of the transfer as a sublease. Perhaps alone among the states, Arkansas has rejected the common law test in favor of an individualized test of intention. *Jaber v. Miller*, 239 S.W.2d 194 (Ark. 1951). In finding that a sublease rather than an assignment was intended, the majority of the Arkansas Court of Appeals relied on three factors: (1) the parties labeled the instrument of transfer a "sublease," (2) the transferee paid rent to the tenant rather than to the landlord, and (3) the tenant had reserved a right of re-entry in the instrument of transfer. A dissenting judge argued that there was equally compelling evidence that a sublease rather than an assignment was intended: (1) the amount of the rent paid by the transferee to the tenant was the same as the rent reserved in the top lease, (2) the instrument of transfer incorporated all the terms of the top lease, and (3) the transfer could be construed to be for the entire remaining term since the options to renew were also transferred.

Even accepting that the transfer was a sublease rather than an assignment, one might question the ruling that equitable relief should be limited to assignees and not subtenants, as objected by both dissenting judges. How was the landlord injured when the exact amount of the rent reserved was received? The landlord had agreed to a fixed rent for a long term (10 years) and potentially an even longer term (30 years more) if the options were exercised. Was the landlord merely looking for an excuse to terminate? Was forfeiture fair to the defendant?

**11. M.P.M. Builders, LLC v. Dwyer, 809 N.E.2d 1053 (Mass. 2004). Landowner whose land is burdened by an easement may relocate the easement after a judicial determination of appropriateness despite objection by the easement owner.**

Defendant Dwyer purchased a parcel of land and an appurtenant right-of-way easement over an adjacent parcel in 1941. The deed to Dwyer described the location of the easement but contained no mention of possible relocation by either the easement owner or the burdened landowner. In 2002 plaintiff M.P.M. Builders, owner of the burdened parcel, proposed to relocate the easement to accommodate building houses on the parcel. The relocated easement would permit Dwyer's access "in the same general area" as the deeded easement; the cost of construction would be borne by M.P.M. Builders. Dwyer refused permission, "preferring to maintain [his] right of way in the same place that it has been and has been used by [him] for the past 62 years."

M.P.M. Builders sought a declaratory judgment that it could relocate the easement without the owner's permission. A Land Court judge, relying on the common law rule in effect in Massachusetts forbidding relocation without permission, granted summary judgment in favor of Dwyer. The Massachusetts Supreme Judicial Court, abandoning the common law rule insofar as it concerns relocation by a burdened landowner and adopting instead the test in the Restatement 3d: Servitudes with the qualification that prior judicial approval be secured, reversed and remanded.

The case is the latest in a series concerning the relocation of easements, sparked by the abandonment by the Restatement of the common law rule forbidding relocation without permission. Section 4.8 (3) allows the burdened landowner to relocate the easement under certain circumstances without the easement owner's permission:

- Unless expressly denied by the terms of an easement . . . , the owner of the servient estate is entitled to make reasonable changes in the location or dimensions of an easement, at the servient owner's expense, to permit normal use or development of the servient estate, but only if the changes do not
- (a) significantly lessen the utility of the easement,
  - (b) increase the burdens on the owner of the easement in its use and enjoyment, or
  - (c) frustrate the purpose for which the easement was created.

Although the Supreme Judicial Court admitted that Massachusetts law at the time the easement at issue was created prohibited relocation without consent and that subsequently created easements can include express prohibitions on relocation without consent, it refused to accept that the original parties intended to rely on the then-current law when they failed to mention relocation. Going forward, easement drafters should consider specific provisions concerning relocation.

It is noteworthy that the new default rule does not apply to the relocation of easements by their owners. In such cases silence is presumed to mean that the parties intended that there be no relocation without permission.

**12. Spears v. Boyd, 313 B.R. 212 (W.D. Mich. 2004). Bankruptcy filing by a debtor holding property as tenancy by the entirety with her non-debtor spouse does not sever the tenancy and make the debtor's interest available to her individual creditors.**

Debtor in Chapter 7 bankruptcy listed real estate held with her non-debtor spouse in tenancy by the entirety and claimed it as exempt from her individual creditors. Although Michigan law exempts entirety property from the claims of individual creditors of an indebted spouse, a bankruptcy judge ruled that the filing of bankruptcy by a Michigan debtor severed the tenancy by the entirety as a matter of federal law and converted it into a tenancy in common. Although Michigan law forbids transfer or encumbrance by one spouse, the bankruptcy judge ruled that the Bankruptcy Code overrides state law. The U.S. District Judge for the Western District of Michigan in a sharply worded opinion reversed the bankruptcy court and reinstated the Michigan exemption against the claims of all but joint creditors.

Tenancy by the entirety was the common law marital estate. In modified form it is now available to married persons in about half the states. In some states, it is treated as a specialized form of joint tenancy, one inseverable by the act of either spouse. In these states the creditor of an indebted spouse can reach the interests of the spouse in the entirety property, among them the right of survivorship in the whole and the right to an equal share if the tenancy ends by divorce. For purposes of bankruptcy, this form of tenancy by the entirety has been described as a partial bar to the claims of creditors. Other states – Michigan among them – are described as “full-bar jurisdictions,” and entirety property is subject only to the claims of creditors of both spouses and no interest in it can be reached by creditors of the debtor alone. In 2002 in *United States v. Craft*, 535 U.S. 274 (2002), the U.S. Supreme Court held that a federal tax lien attached to the interest of a Michigan tax debtor in property held with a non-debtor spouse in tenancy by the entirety, in effect adopting as federal law for purposes of federal tax collection the concept of tenancy by the entirety as an inseverable joint tenancy and only a partial bar to the federal tax collector.

The present case is noteworthy less for its holding, which is standard fare, than for the position it rejects. Whether *Craft* would open the door to the claims of private creditors has been much discussed. In this case a bankruptcy court took *Craft* one step further, holding that a filing in bankruptcy severs the tenancy by the entirety. The logic of the decision is that interests in a tenancy by the entirety in Michigan, and by extension in all “full-bar jurisdictions,” although inalienable by one spouse under state law, are made transferable by federal law in case of bankruptcy, and that the transfer in bankruptcy severs the tenancy by the entirety, converting it into a tenancy in common. Of course, it is unlikely that creditors in Michigan could have anticipated this result and extended credit in reliance on it: in the twenty years since the adoption of the latest Bankruptcy Code no other court has reached this result. And, although it is possible for federal law to override state law concerning tenancy by the entirety, as *Craft* demonstrated, it is also possible for federal law to do any number of things other than converting it into a tenancy in common, including converting it into an inseverable joint tenancy – or continuing to exempt it from the claims of individual creditors altogether.

**13. General R.A.C. Inc. v. Coldwell Banker Real Estate, Inc., 876 So. 2d 606 (Fla. 3d DCA)(2004). Is a purchasers' deposit in a real estate transaction subject to garnishment by a creditor of the vendor? Does a deposit lose its homestead protection? District Court of Appeal of Florida says "No" to both questions.**

Isaac and Elbaz Dienemann (sellers) listed their homestead property for sale, agreeing to pay a 7% commission to Coldwell if a buyer was found. Coldwell found buyers and agreed to serve as escrow agent for the buyers' \$10,000 deposit. General, a judgment creditor of the sellers, served a writ of garnishment upon Coldwell. Coldwell answered, acknowledged possession of the deposit money, but denied possession of any money owed to General.

The trial court denied general's motion. The court held that a deposit held in escrow was neither a debt nor property of the judgment-debtors. Thus, Coldwell was entitled to retain the deposit in payment of its commission on the transaction.

A previous decision of the District Court had held that "funds held in an escrow account ....for partial payment of a real estate commission were equitably owned by the brother...[and] not subject to garnishment." Estate of Bain v. Bibolin, 737 So. 2d 1238 (Fla. 3d DCA 1999), rev. denied, 751 So. 2d. 1250 (Fla. 2000)

General argued that the amendments made to certain sections of the Florida Statutes effectively overruled the Bain decision. The court found that the amendments were not relevant to this situation. Further, the court concluded that although the \$10,000 did not lose its homestead protection, the proceeds remaining in the sellers' possession could lose their homestead protection if not used to purchase a new homestead within a "reasonable time."

**14. Coldwell Banker Residential Brokerage Company, Inc. v. The Superior Court of San Diego County, 117 Cal App. 4<sup>th</sup> 158, 11 Cal Rptr. 3d 564 (2004) Do the statutory inspection and disclosure duties of a residential real estate broker impose on the broker a duty of care toward a minor who develops asthma caused by toxic mold in a house? The court held that the broker is not liable.**

Maria Casteneda purchased a home. Coldwell Banker was the listing agent. After Casteneda and her minor son moved into the home, she noticed a moldy smell in the kitchen and in the downstairs bathroom. Environmental testing showed a dangerous level of mycotoxins and mold spores. The estimated cost to fix the problem was over \$25,000. Both Casteneda and her son became ill and the son developed asthma.

Casteneda's minor son Marcos sued Coldwell. His second cause of action was for negligence; he argued that as a licensed real estate broker Coldwell owed him a duty under California Civil Code § 2079 to "...conduct a reasonably competent and diligent inspection of the property and to disclose known or reasonably ascertainable defects, including the presence of dangerous microbial contamination." In other causes of action, the son alleged nuisance, intentional infliction of emotional distress, fraud and misrepresentation.

The broker demurred to the complaint, but the trial court overruled the demurrer and found that the minor son stated a cause of action for negligence, nuisance and the intentional infliction of emotional distress.

The appellate declared that generally real estate brokers are subject to two sets of duties: statutory and those arising out of general agency principles. The court found that under the facts any discussion of liability based on agency principles were inappropriate. The court found that the statutory inspection and disclosure duties of real estate brokers and their agents "...apply exclusively to prospective buyers, **and not to other persons who are not parties to the real estate transaction.**" The court determined that there was no broker-customer relationship between Coldwell and Casteneda's minor son. Further, the court held that Marcos was no an "intended beneficiary of factual disclosures regarding the value and desirability of the house. The court also found no broker liability based on "foreseeability." Lastly, the court found that the broker's conduct was not affirmative and willful.

**15. Howard v. Berkman, (Supreme Court, New York Law Journal, 11/17/2004). In a transaction involving a sale of a house, can a lawyer be liable for malpractice for failure to obtain at least a temporary certificate of occupancy prior to allowing title to close? The court says “yes.”**

A law firm represented the buyer of a house. The transaction was allowed to close without the production of a temporary certificate of occupancy. As a result the buyer was unable to move into the house and received a housing violation for the premises.

Howard sued the law firm for malpractice. The court reviewed the problems created by allowing temporary rather than final certificates of occupancy. It explained that the policy, originally aimed at allowing people to occupy building that still needed minor work not affecting safety concerns, has resulted in premise not having final certificates of occupancy, and possibly being unsafe, for year. The court ordered the Department of Buildings to show cause why an order should not be issued permanently enjoining the issuance of temporary certificates of occupancy. The court also found legal malpractice on the part of the law firm.

**16. Resnick v. Meybohm Realty, Inc., 269 Ga. App. 486, 604 S.E. 2d 536 (2004) Did real estate agents for both the purchaser and the vendor breach a duty by concealing a known defect in a gas line or by failing to investigate the source of odors in a home? The court held that neither the purchaser's real estate agent nor the vendor's real estate brokerage firm breached a duty.**

Frances Resnick decided to move from Toronto, Canada to Augusta, Georgia in 2000. She signed an exclusive brokerage agreement with Meybohm in January, 2000. She visited a home accompanied by a Meybohm agent. An agent for the seller was also present when she visited the home. The Meybohm agent assured Resnick that the home was "in absolute[ly] perfect condition." The seller's agent echoed this sentiment. While walking through the house Resnick detected a few problems, including a "very heavy odor" that indicated that something was decaying inside the house. Upon inquiring about the odor, both agents said that the house did have "some dampness" and needed a drain. Resnick offered to purchase the house and the offer was accepted. After the offer was accepted Resnick hired someone to inspect the house. The inspection report summary indicated that the house was in "good condition." Two months later, a gas explosion occurred in the house just after Resnick had ignited a gas stove pilot light. Resnick was injured. An investigation of the incident revealed a gas leak in the home fireplace caused an explosion in the house.

Resnick sued both agents, alleging that they had breached various duties to her by misrepresenting the condition of the house, concealing evidence of a gas leak, and convincing her to pay an inflated price for the house. The trial court granted summary judgment to both defendants. In particular, the trial court held that the merger clause in the Purchase and Sale Agreement estopped Resnick from arguing that she justifiably relied on or was induced by any alleged misrepresentations. The appellate court found no error by the trial court.

The appellate court found that Resnick made no effort to rescind the contract or to sue to recover the purchase price. Instead, she affirmed the contract and sought recovery for damages. As such, she was "bound by the contract's terms and is subject to any defenses which may be based on the contract." Thus, her claims regarding misrepresentation were barred by the contract's merger clause. The concealment claim did not survive summary judgment because the record contains no evidence that the defendants knew about the gas leak before the explosion. As for the duty to investigate, there was no evidence in the record that the real estate agents breached a duty to Resnick by failing to investigate the source of the odor in the house. Further, they suggested that she have the house inspected and the inspection did not detect a gas leak or any other dangerous condition in the house.

**17. Hasler v. Howard, 120 Cal. App. 4<sup>th</sup>, 16 Cal Rptr. 3d 217 (2004). Does an attorney fee clause, which is limited to actions regarding a broker's compensation, cover fees incurred by a broker in a seller's fraud action. The court says "no."**

Howard acted as Hasler's broker in the sale of a home. The listing agreement contained a clause providing for attorney fees to the prevailing party in any action regarding the broker's compensation. The house was sold, but Hasler sued Howard for fraud, breach of fiduciary duty, and breach of a duty to disclose. Hasler claimed that Howard sold his home for a price below its value. Her complaint did not request a return of Howard's commission.

In a settlement conference between the parties, Hasler offered to compromise his claim for the commission, but the case did not settle. Thereafter, Hasler voluntarily dismissed his complaint. Howard then moved for attorney fees, offering the settlement statement as evidence that the broker's commission was an element of Howard's damages claim. At trial, the court excluded the settlement statement and denied Howard's motion for attorney fees. Howard appealed and the appellate court affirmed the trial court's decision.

In affirming, the court of appeal held that the settlement statement was inadmissible under Evid C § 1152(a), which prohibits admission of an offer made in compromise, as well as statements made in negotiation thereof., for the purpose of providing a person's liability for loss. In addition, the court also rejected Howard's argument that the listing agreement attorney fee clause covered Hasler's tort actions. The appellate court agreed with the trial court that Hasler's action for fraud and breach of duty did not involve the obligation to pay the broker's commission.

**18. Oat Note, Inc. v. Ampro Equities, Inc., 141 S.W. 3d 274 (Ct. App, Texas, 2004) Does an “as is” clause in a real estate contract preclude recovery for negligent misrepresentation? The court says it does not.**

In 1997 Oat Note entered into a contract with M & L England to sell land in a commercial subdivision to be used by M & L as a gymnastics training center. The contract provided that M & L was required to improve an existing low-water crossing pursuant to city regulations. The contract further required Oat Note to construct a highway to the low-water crossing on the land it retained adjacent to that sold to M & L. Oat Note was obligated to finish construction on the highway within sixty days of the completion of the low-water crossing. M & L completed the low-water crossing improvements in March 1998.

Thereafter, Oat Note entered into a contract with Ampro to sell four commercial lots adjacent to the lot previously sold to M & L. Ampro assumed the obligation to construct the highway. Ampro turned its attention to other projects on the newly acquired land and did not complete the highway. M & L brought suit against Oat Note and Ampro, alleging breach of post-closing construction obligations. Ampro settled with M & L for \$35,000. Ampro subsequently filed a cross-claim against Oat Note for the entire settlement amount, claiming that fraudulent and negligent misrepresentations regarding the construction obligations resulted in the loss. Oat Note responded with a cross-claim, stating that the “as is” provisions in the contracts between the parties determined the dispute. The trial court followed the jury’s recommendation and found for Ampro. Oat Note appealed.

According to the appellate court the “as is” clause in the contract between the parties did not preclude M & L from recovering for negligent misrepresentation because M & L damages were caused by Oat Note misrepresentation concerning the completion of the low-water crossing, not by a disagreement over the value of the land itself or any other assertion about the condition of the property conveyed.

**19. Keystone Land & Development Company v. Xerox, 152 Wash. 2d 171, 94 P. 3d 945 (2004). Does a written response to an offer that says “we are prepared to negotiate a Purchaser and Sale Agreement with you subject to two modifications to your proposal” create a duty good faith to bargain or to bargain exclusively when the recipient of the response agrees to the stated modifications? The Supreme Court of Washington holds that such language does not constitute a ‘contract to negotiate.’**

Xerox decided to sell and leased a facility it owned on Tukwila, Washington. Xerox was represented by a broker and was apparently negotiating with several parties, including town of Tukwila. The broker wrote to both Keystone and the City (who had sent in initial bids) to send in their “final, best offer.” Keystone did so and indicated that its offer would expire if not accepted prior to April 16, 2001. On April 13, Xerox responded to Keystone by having its broker send Keystone a letter containing the “two modifications” language. Keystone agreed to the modifications, and expected to receive a contract for execution. Xerox had been conducting parallel negotiations with the City and ultimately signed a contract with the city.

Keystone brought suit in federal court and the federal court certified to the Washington court the question of whether Washington courts recognize a duty to negotiate in good faith on the basis of the exchange between Keystone and Xerox.

The Washington court did indicate that it is possible that a duty to bargain in good faith could arise following the exchange of letters of intent. It further acknowledged that there is an implied covenant and fair dealing in every contract executed in the state of Washington. It found, however, that such a duty can only arise if there is a contract. Since the court concluded that the facts of the exchange between Xerox and Keystone did not give rise to an interference a contract of any kind was created. Accordingly, a duty of good faith did not arise.

**20. PNC Bank v. Axelsson and A&J Fish Company, Inc., 373 N.J. Super. 186, 860 A.2d 1021. A mortgagee that purchases the mortgaged property at a foreclosure sale takes the property subject to an unrecorded easement of which it had prior notice.**

Defendant Axelsson operated a restaurant and obtained a parking easement on an adjacent property owned by co-defendant A&J Fish Company in 1988. The easement was not recorded, although it had been received by the county clerk's office. A&J mortgaged the property to plaintiff PNC Bank in 1999. A&J defaulted on the mortgage, and defendant PNC obtained a foreclosure judgment (April 2001), purchased the property at sheriff's sale (January 2002), and obtained a writ of possession (March 2002). Defendant Axelsson was not a party to the foreclosure action or any of the subsequent proceedings because they were not notified of them. PNC joined Axelsson in a post-judgment, post-sale application to extinguish the unrecorded parking easement. Whether PNC had prior knowledge of the parking easement was not specified. PNC argued the foreclosure cut off the unrecorded easement irrespective of its knowledge of the lien. Axelsson argued that where the mortgagee is the purchaser at foreclosure sale, the easement is extinguished only if the mortgagee did not know about the unrecorded interest.

New Jersey is a race-notice jurisdiction such that between two competing interests, the party who records first prevails over an unrecorded prior interest. That priority exists only where the first party to record did not have knowledge of the other party's unrecorded interest. Cox v. RKA Corp. 164 N.J. 487, 496 753 A. 2d 1112 (2000). The general rule is codified in NJSA 46:22-1 such that here, if plaintiff knew of defendants' unrecorded interest when it took the mortgage, the statute would validate the unrecorded easement against the bank. The goal of the statute is to afford protection to unrecorded interests.

Foreclosure actions are an exception to the general rule. New Jersey's policy that title acquired at a judicial sale held pursuant to a foreclosure judgment is best given to a purchaser free from any latent inequities was codified in NJSA 2A:50-30, providing that the holder of an unrecorded interest is bound by the judgment in a foreclosure action as if it had been a party. The courts have interpreted this statute to mean the purchaser at a foreclosure sale acquires title free of any unrecorded interest, even where it had notice of the unrecorded interest. This additional measure of finality ensures the highest price possible from the sale.

Here, in a case of first impression, a foreclosing mortgagee with knowledge of an unrecorded interest buys at a judicial sale. The court held that a mortgagee with knowledge should not receive the benefit of the NJSA 2A:50-30 and be able to better its position with respect to a previously existing unrecorded interest through a judicial sale. To hold otherwise would give an incentive to the mortgagee with knowledge not to inform the holder of an unrecorded interest notice of the foreclosure, thereby terminating the interest. A foreclosing mortgagee who purchases is in a different position than a third-party purchaser.

**21. Kearns v. Transamerica Home Loan, 314 B.R. 819, 54 UCC Rep. Serv. 2d 958, 4 Cal. Daily Op. Serv. 9956, 2004 Daily Journal D.A.R 11, 923.** “This secured consumer loan question of apparent first impression requires that we harmonize California’s so-called “one-action/security-first” real estate foreclosure statute with its “mixed collateral” variation of the UCC sec. 9-604, which relegates enforcement of rights when one loan is secured by both real and personal property. The narrow question is whether the exercise of nonjudicial remedies against personal property collateral under the California Commercial Code sec. 9604 renders unenforceable a lien on real property by virtue of California Code of Civil Procedure sec. 726. Thus, rather than being a “one-action/security first” case, this is a “one-action/which security first?” case.”

Consumer borrowers, the Kearns, borrowed \$34,000 from lender, Transamerica, and gave lender two separate liens; one in an automobile and one a deed of trust on real estate. Five months later the borrowers filed for chapter 7 bankruptcy protection and received a discharge that eliminated their personal liability on the debt, but did not affect the liens held by Transamerica. The borrowers made some post-bankruptcy payments on the loan, but ultimately defaulted and Transamerica nonjudicially repossessed and sold the automobile in a “commercially reasonable” manner pursuant to Article 9. When the Kearns attempted to sell their home and Transamerica placed a demand in escrow of \$17,000 of the sale proceeds, after it refused to reconvey the deed of trust.

The borrowers objected to the lender’s demand, arguing that the repossession and sale of their automobile satisfied the real property lien, and sued Transamerica in Bankruptcy Court. The issues in the case were whether the actions taken by Transamerica pursuant to the California Commercial Code offended either the “one-action” or “security-first” aspects of California’s Code of Civil Procedure, such that the deed of trust on real property was unenforceable.

California Code of Civil Procedure sec. 726(a) provides that only one action is permitted to recover a debt or enforce a right secured by mortgage upon real property. This statute “has been construed to mean that in the event of a default, a secured creditor must, in a single action, first exhaust all its security as a condition of obtaining a monetary deficiency judgment against a debtor personally.”

The California Commercial Code sec. 9604, the newly enacted “mixed collateral” statute, states:

- (a) if an obligation secured by a security interest in personal property or fixtures is also secured by an interest in real property or an estate therein:
  - (1) the secured party may do any of the following:
    - (A) Proceed in any sequence, (i) in accordance with the secured party’s rights and remedies in respect of real property as to the real property security, and (ii) in accordance with this chapter as to the personal property or fixtures.
    - (B) Proceed in any sequence, as to both, some or all of the real property and some all or all of the personal property or fixtures in accordance with the secured party’s rights and remedies in respect of the real property, by including the portion of the personal property or fixtures selected by the secured part in the judicial or nonjudicial foreclosure of the real property in accordance with the procedures applicable to real property..

The Bankruptcy Court held that the sale of the vehicle pursuant to the California Commercial Code did not offend the “one-action” provision of the Code of Civil Procedure because a nonjudicial foreclosure was not an “action” within the meaning of the Code of Civil Procedure. Rather, a nonjudicial foreclosure is usually “a sale by a trustee under a power of sale in a deed of trust without any invocation of the power of a court.”

Second, the Court held that the sale of the vehicle pursuant to the California Commercial Code did not violate the “security-first” aspect of the Code of Civil Procedure. In this case, there were two items of collateral securing a single debt; “security” and “additional security”. A creditor may resort to additional security following a nonjudicial foreclosure. The sequence in which security is called does not make a difference.

**22. Broadway Bank v. Star Hospitality, Inc. et al., 2004 WL 2677658 (Nov. 24, 2004), Court of Appeals of Iowa. Prepayment penalty provision in mortgage loan agreement was unenforceable where clause did not distinguish between voluntary and involuntary prepayment and bank's decision to accelerate debt and file foreclosure action resulted in involuntary prepayment.**

Plaintiff mortgagee Broadway Bank loaned \$3,494,000 and granted a mortgage to defendant mortgagors for a hotel property in Davenport, Iowa. The mortgage was subsequently assumed by an individual, Syed Quadri, who granted the bank a "first interest and assignment of rents against the hotel" as collateral for the loan. Additional collateral, in the form of "CDs held in the name of the debtors and guarantors" (including a CD from Quadri in the amount of \$532,229) as well as assignments of rents and second mortgages on Quadri's residential properties in Illinois, was also obtained by the bank. The aggregate value of this collateral was approximately \$20 million.

The prepayment provision in the loan documents provided that if the principal amount of the loan was reduced by twenty percent in a one-year period, the prepayment penalty would be assessed equal to six months' interest. The loan documents also provided for a late charge of five percent and default interest of "ten points over the index upon default," and for the collection of attorney's fees if collection was necessary.

When hotel revenues waned in late 2001, the bank granted Quadri a delay of three to four months to make payment on the loan. Quadri asked the bank to cash his CD and apply the money to the past-due balance, bring the loan current and make future loan payments (the loan called for monthly payments of \$33,014.99). The bank did not do so believing it would be left with insufficient collateral, and no payments were made on the loan. Quadri subsequently contacted the bank and inquired whether he could use the CD as collateral to secure a new loan at another bank and refinance the debt. The bank informed him that it had in fact converted his CD to a non-interest bearing account and had applied \$192,574 to the outstanding loan balance, which brought the loan current within 30 days (but not completely current). The bank continued to charge default interest on the unpaid principal while still maintaining the remainder of the money for collateral.

The bank filed a foreclosure action in March 2002. The parties negotiated a settlement agreement providing for a "settlement sum" of \$3,250,000 to be paid by the defendants. The settlement agreement also provided that the defendants continued to owe an unpaid principal balance on the loan of \$259,672, interest thereafter at 10.5%, mortgage release fees, and legal fees. The issues of the late charges, default interest, attorney's fees and, the prepayment penalty were preserved for later resolution. Defendants agreed to submit these issues to arbitration, mediation or litigation within sixty days-but the failed to do so.

Seven months later, in November 2002, the bank filed a declaratory action, seeking \$524,479, which included outstanding principal, late charges, default interest, attorney's fees, and the prepayment penalty. The trial court held an evidentiary hearing and awarded the bank \$80,661.90 which included the principal owed of \$70,493, interest on that amount from September 9, 2002 until the time of the ruling in the amount of \$5,168 and \$5000 in attorney's

fees. The court subsequently modified its ruling to allow a one-time late fee of five percent of the unpaid principal balance and increased the award of attorney's fees to \$50,000 (increasing the total award to \$129,186).

The trial court did not award default interest or prepayment penalty. Default interest was not due, according to the court, because Quadri attempted to pay the loan with his CD, the bank did not have a good faith belief that it was insecure, and the default was the result of the bank refusing to use the CD. A prepayment penalty was not awarded because the payment was "involuntary" and such an award would constitute unjust enrichment. The trial court reasoned that because the bank chose to accelerate the debt and commence a foreclosure proceeding, the defendants had not voluntarily "prepaid" the loan and the bank was not entitled to collect the prepayment penalty.

The appellate court reversed the holding of the trial court with respect to default interest, rejecting the trial court's finding that the bank had not acted in good faith in deeming itself insecure because the defendants were not in default due to Quadri's attempts to make payment on the loan by applying his CD. According to the appellate court, "The language of the promissory note regarding late charges, and default interest are [sic] clear and unambiguous. The settlement agreement between the parties did not extinguish [the bank's] ability to collect late charges and default interest. Rather, the agreement reserved defendants' right to adjudicate the issues at a later time. The availability of collateral to be used as a set-off is irrelevant to the issue of whether defendants were in default." The court further noted that even though Quadri was allowed to delay his loan payments for three or four months, he had failed to make any payments beyond that time.

With respect to the prepayment penalty, the appellate court concurred with the trial court's analysis and refused to permit the bank to collect the penalty, stating that "[t]he language of the promissory note does not distinguish between voluntary and involuntary prepayment." The court cited a Seventh Circuit bankruptcy decision, *In re LHD Realty Co.*, 726 F.2d 327, 330 (7th Cir. 1984) for the proposition that "where a lender accelerates a debt, the right to prepayment is lost." The court also found that "under the Illinois law governing the action [the bank] is not entitled to the prepayment penalty."

**23. Delta Rault Energy 110 Veterans, LLC v. GMAC Mortgage Corporation**  
**2004 WL 1752859, U.S. District Court, E.D. La.**

Plaintiff mortgagor obtained short term financing in the amount of \$8,200,000 from defendant mortgagee to purchase a building. The promissory note executed by the parties contained a provision for an “Exit Fee” equal to 1% of the original principal amount of the loan, which could be waived if defendant provided permanent financing for the property. Plaintiff obtained permanent financing from another lender, and had to pay off the mortgage from defendants to close the second loan. Plaintiff paid an exit fee of \$82,000 to satisfy the mortgage with defendants, and then, subsequently filed suit to recover the exit fee payment and damages for defendant’s alleged delayed repayment of reserve account deposits.

Defendants filed a motion to dismiss for failure to state a cause of action, contending that the terms of the exit fee are clear and unambiguous and, therefore, no further evidence is admissible under the Federal Rule 12(b)(6). Plaintiff’s responded that the provision is ambiguous and led to absurd consequences; that defendant “waived the exit fee by failing to negotiate for permanent financing in good faith and at market pricing;” and that the exit fee is an invalid stipulated damages clause under Louisiana law.

The court first addressed the classification of the exit fee. Plaintiff asserted the exit fee was similar to a prepayment penalty, and was invalid as a stipulated damages clause because it did not reasonably approximate the damages incurred from early prepayment of the loan. Under Louisiana law, there must be an attempt to relate a prepayment penalty or stipulated damages to the consequences of prepayment to the lender. The court ruled that exit fees are commonly encountered in short term financing, therefore they not automatically considered prepayment penalties or stipulated damages. Instead, the court reasoned, exit fees are either an additional fee connected to the loan or deferred interest as additional consideration for defendant to make the loan.

The second issue concerned whether the exit fee provision was ambiguous, requiring extrinsic evidence to explain the parties’ intent. Plaintiff claimed an ambiguity arose from an omission in the promissory note. The loan application letter stated defendants would waive the exit fee if it provided “permanent financing at market pricing,” however the promissory note provided for waiver of the exit fee if the defendants provided “permanent financing.” The court ruled that the exit fee provision in the promissory note was clear and unambiguous, and parole evidence (such as the loan application letter) was inadmissible to determine the intent of the parties. It was also pointed out that the loan commitment letter contained language stating “nothing herein shall be construed as a commitment by the lender to either provide ...permanent financing,” and that the parties were sophisticated and represented by counsel in negotiating and executing the contract. The court won’t consider extrinsic evidence based on looking at extrinsic evidence-the loan commitment letter.

(Based in part on the ABA Quarterly Report Fall ’04)