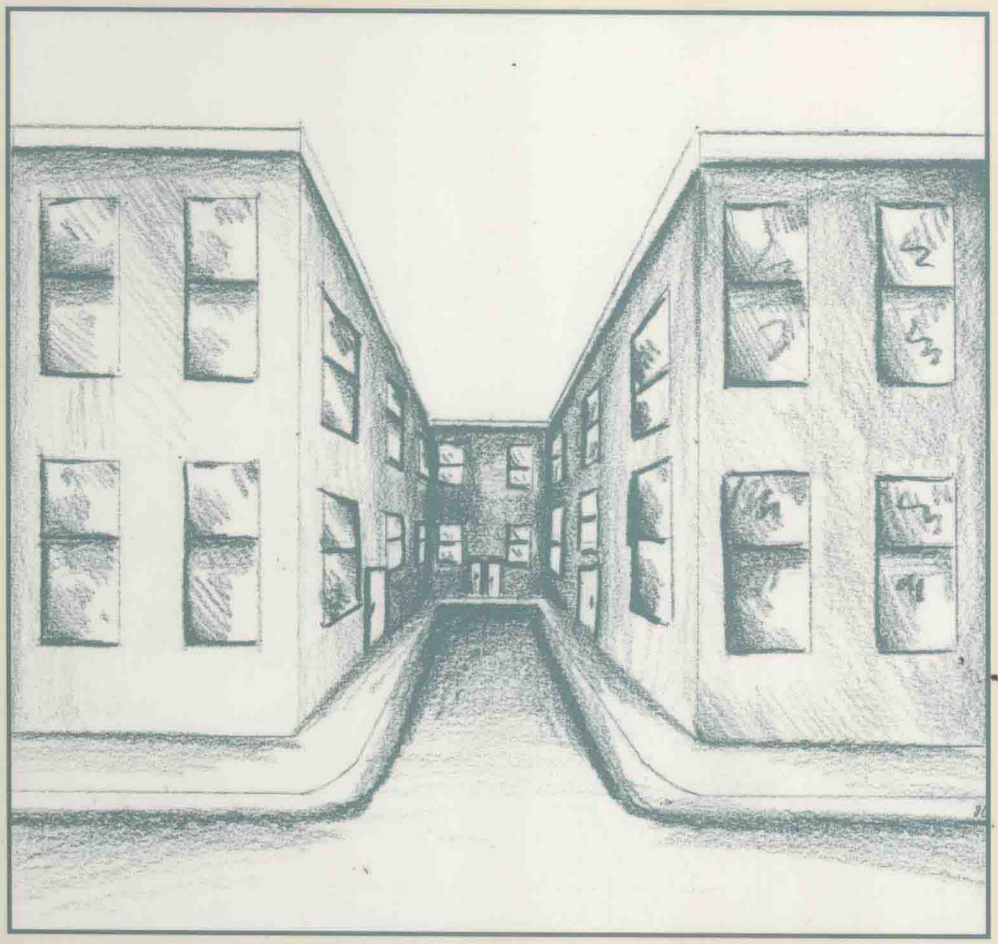
EXAMPLES & EXPLANATIONS

Real Estate Transactions

Fifth Edition

Barlow Burke



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Aspen Publishers
Attn: Order Department
PO Box 990
Frederick, MD 21705

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

ISBN 978-0-7355-8855-4

Library of Congress Cataloging-in-Publication Data

Burke, D. Barlow, 1941-
Real estate transactions : examples and explanations / Barlow Burke. — 5th ed.
p. cm.
Includes index.
ISBN 978-0-7355-8855-4 (alk. paper)
1. Vendors and purchasers — United States — Problems, exercises, etc.
2. Conveyancing — United States — Problems, exercises, etc. 3. Mortgages — United States — Problems, exercises, etc. I. Title.

KF665.Z9B865 2011
346.7304'37076 — dc22

2010046952

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Preface

This book is intended to supplement law school elective courses in real estate conveyancing and transactions, mortgages and finance, and business planning and investment in real property. First-year students whose basic property course deals with real estate transactions will also find many parts of the book helpful. *Real Estate Transactions: Examples and Explanations* covers basic information needed for these courses and deals with the issues and leading cases likely to be discussed in class. It is divided into three parts: transactions, financing, and business planning.

Real Estate Transactions: Examples and Explanations begins with simple residential transactions and proceeds to more complex commercial transactions. It discusses the various actors who play a role in these transactions and presents them in the chronology in which they are likely to appear. This book traces the general organization of the leading casebooks on the subject.

Explanations of the examples (or problems) are provided for your convenience. After reading the examples, I recommend that you pause to think about your answer. You will profit from considering your own explanation, and you may enjoy arguing with mine. That kind of mental engagement is the real value of a book like this.

The five editions of this book have been prepared during very different real estate markets. Many of the additions to the current edition reflect recent changes in the marketplace, particularly in the mortgage market.

This edition has retained the most valuable features of its predecessors: condensed documents of various types, abridged statutes, and, above all, example after example. New examples emphasize trends in the current market. Examples from the previous editions that proved especially instructive have been retained.

My hope is that this book will help students to understand the issues and cases that make up real estate transactions, a fascinating and basic field within the general practice of law.

Barlow Burke
November 2010

Acknowledgments

A teacher is constantly learning and relearning the subject he teaches. I am grateful, first, to the authors of the many casebooks I have used over the years, as well as the authors of the treatises I've consulted and of the numerous law review articles and cases I read to stay current. Second, my students' comments and questions in class have proven to be a wellspring for this book. I thank them all, too numerous to mention. Third, all my research assistants over the past decade—Julie Richmond, Catherine Brown, Les Alderman, Stephanie Quaranta, Catherine Thomas, Meryl Eschen, Michael Vila, and for this edition particularly, William Weaver—have pursued the answers to my questions with steady and patient research. Finally, Aspen Publishers has provided steady encouragement and excellent support. I thank all.

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Law of Conveyancing

1 American Conveyancing and Professional Responsibility

An attorney's practice in this country is likely to present matters arising in residential purchase and sales and/or commercial transactions involving real property. In the former capacity, the real estate attorney functions amid the work of many other actors — brokers, property inspectors, surveyors, mortgage lenders, appraisers, title abstractors, and title insurance companies, to name a few of the principal ones. Succeeding chapters will deal with each of these. Often residential work comes to the attorney's attention in mid-transaction — most significantly, after the contract of sale has been executed. Thus, often in residential sales practice, the attorney's role is limited by the contract, and is limited to interpreting the contract as the executory period proceeds.

In commercial real estate transactions, the attorney's role is similar to that of an attorney in other areas of corporate or commercial practice. The attorney is interested in limiting the risks the client faces in proportion to the rewards the client expects. This entails a balancing of business and legal concerns in the context of reviewing the title of the property to be purchased, selecting a note and mortgage, and negotiating their covenants. The following documents detail the typical transaction.

1. The broker's listing agreement. It is the real estate broker's employment contract and defines the terms of the broker's agency with the vendor. The purchaser in a commercial transaction may employ a broker as well.
2. The contract of sale. Whether the attorney helps negotiate the contract or is given it only after the fact to interpret and implement, the

contract is the product of two English statutes: the Statute of Frauds (1677), one of whose sections required a writing for the transfer of interests in real property, and the Statute of Uses (1535). The latter statute validated a new form of future interests, known as executory interests. (Thus the period of time between the execution of the contract and the closing is known in this country as the "executory period.") Americans have taken the common law contract of bargain and sale, added the idea of an executory contract as it developed in the eighteenth century, and adapted it for use in this country — that is, filled it with conditions, contingencies, and "subject to" clauses. In some regions of the country, escrow instructions implement the contract.

3. The note, along with a mortgage or deed of trust. These provide the two financing instruments — an IOU and a security agreement for the loan — necessary for either the vendor or a third-party (often institutional) lender to provide a loan to finance the purchase of the property.
4. Closing documents. The deed from the vendor to the purchaser, plus a welter of documents that (1) account for the money changing hands in the course of the transaction, (2) protect the lender from defenses to the note or mortgage, (3) protect the purchaser's title as offered by the vendor (e.g., an attorney's title opinion or a title insurance policy), or (4) indicate compliance with various state and federal consumer and regulatory statutes. Americans do not use the common law forms of conveyances. Instead we have adopted statutes authorizing the transfer of title to real property by simple forms for deeds and also authorizing recording all documents transferring an interest in realty on public land records. The documents memorialized on the public record are available later as evidence of the history of the title transferred.

An attorney may be involved in the preparation of all of these documents, ranging from filling them out to drafting them completely. Whether in residential or commercial work, the attorney is arranging a transaction that both parties consider will work to their benefit, adjusting the risks to be commensurate to the benefits expected by the client. The work is not adversarial in the same sense that litigation is — although, in changing markets and circumstances, it can come to that. It is when markets and circumstances change or unanticipated risks arise that professional responsibility issues also are likely to arise. Those issues are the subject of the next section.

With the Statute of Uses providing a legal mechanism for executing contracts of sale and the Statute of Frauds requiring written contracts and deeds, Americans added another new element to their conveyances — the public record, from which vendors could show title to their purchasers. The

system of public records, maintained typically at the county or city level, relies on each and every purchaser of an interest in real property promptly recording it.

The earliest purchasers were interested in only one interest or estate in real property — the full fee simple absolute. Anything less felt reminiscent of the feudal relationships that Americans had left the Old World to escape. Thus early American legislatures enacted legal reforms to make the fee more freely alienable with regard to feudal interests: They abolished primogeniture, abolished the common law presumption for the joint tenancy with a right of survivorship in favor of the tenancy in common, and limited the common law marital estates of dower and curtesy to land seised at death — all done to make real property free of familial interests. Yet at the same time, they often viewed land as a commercial commodity, so state legislatures created restraints on the fee for commercial interests (such as mechanic's liens and new forms of mortgage liens) — interests unknown in England. Thus, at one and the same time, our conveyancing became both simpler and more complex.

While the public records reflected the state of the title, it yielded its answers as to what a particular grantor has to transfer with some difficulty. With the passage of time, as the records came to reflect a greater number of transfers, this difficulty became extreme. In theory, the records had to be searched on each and every transfer back to the sovereign — the proprietor of the colony, the king, or the state or federal land office patent. Eventually, on the mistaken notion that the Statute of Limitations on every conceivable common law writ had run after 60 years, that length of time came to be the period of search for real property titles. However, in states where land was obtained out of the public domain of the federal government (and so not subject to state statutes of limitations), title is often still searched "back to the sovereign."

Attorneys quickly acquired the skills necessary to search titles, and the law of conveyancing and title search became their domain. Of course, attorneys were not available everywhere and where they were not, deeds drafted by laypersons often became confused. If a deed of bargain and sale (or, in New York, a deed of lease and release) was not used, the lay conveyancer and often the attorney threw in every legal verb that came to mind. Thus the vendor would "give, enfeoff, grant, convey, bargain and sell, lease and release, covenant to stand seised, assign and transfer" whatever property it was that was changing hands. This potpourri of legal verbs eventually came to mean "what I (vendor) have, I transfer it to you (purchaser)." Thus the warranty-free quitclaim deed was recognized. This type of deed is another American conveyancing invention intended to make a title more freely transferable.

A title search is necessary because every purchaser wants to know not only that the vendor is entitled to transfer the title but that the title is "marketable" — that is, is transferred in such a state that it in turn can be transferred to a future purchaser. Even for a quitclaim deed, therefore, the

law read a standard of marketable title into every contract of sale as an implied term. The title-searching attorney's job is to determine whether the vendor is eligible to transfer the title and whether there are any liens or encumbrances attached to it. The attorney's notes on these two issues are gathered together and arranged chronologically into an "abstract of title."

As attorneys did more and more title searches, they accumulated stacks of abstracts as their work product; these abstracts had value if and when they handled a later transfer of the same property. Some firms hired nonattorney employees as title searchers. Thus began the practice of having a lay abstractor search the title and an attorney review the resulting abstract and issue an opinion on the state of the title.

The next question was what to do about abstractor negligence. The possibility of an expensive and time-consuming lawsuit always loomed. Title insurance was devised in response to this threat. The earliest policies were designed to substitute for a vendor's deed warranties and to provide a remedy for abstracting mistakes, as well as to protect against interests that the abstractor could not discover by searching the public records. Thus title insurance policies protected against both record and nonrecord defects. This double coverage became their great selling point. By the beginning of the twentieth century, title insurers were established as abstractors, reviewers, and insurers of titles in many large urban areas. In rural communities, attorneys and abstractors continued to do the business of conveyancing as before. Today, however, the conveyancing industry evidences three patterns for attorney participation. Attorneys function as title searchers, title reviewers, or employees of title insurance companies.

This pattern of participation still means that attorney involvement comes usually after the contract of sale is executed and the executory period under way, at a time when real estate brokers, lender mortgagees, appraisers, property inspectors, and title insurers — and in some regions of the West, escrow agents — are also involved. Some attorneys bemoan this lateness, arguing that the provisions of the contract of sale determine what will happen during the executory period and that, consequently, vendors and purchasers need legal advice while they are still able to affect the provisions of the contract.

In the twentieth century, the reform of American conveyancing patterns has been statutory. One generation of statutes took, the other didn't. First, the failed effort. From the 1890s to the 1930s, more than 20 state legislatures enacted Torrens, or title registration, statutes. Under them, a title search was performed, and a certificate of title reflecting the state of the title was issued; thereafter, a transfer of the certificate, amended to reflect new less-than-fee interests, was a transfer of the title. The states enacting such laws acted with many jurisdictions around the world to implement some versions of a title registry (as opposed to a public records office). In this country, this reform did not take. For many reasons, the Torrens statutes

were repealed or fell into disuse during the 1930s, and a conveyancing reform that had proved efficient for many countries around the world was here discarded. However, a title registry is still available in a few states as an alternative form of conveyancing.

The problem of title searches becoming increasingly longer and ever more mired in paper did not go away. After the Second World War, the process of searching title, no matter how it was conducted, needed further definition, and a second generation of statutes, less comprehensive than the Torrens acts, followed. The problem was this: As time passed, title searches covered a longer and longer period of time and involved ever more diverse types of interests. The need to shorten and simplify them was addressed by two types of state legislation. First, Marketable Record Title Acts shortened the period for the search from the 60-year, common law search to periods of 30 to 40 years. Second, statutes of various types enacted shorter statutes of limitations for encumbrances on the fee simple (particularly for old mortgage liens) and for curing defects appearing on the face of documents on the public records for a certain length of time. Over the years, attorneys have supported enactment of these two types of legislation. These second generation statutes are still with us.

PROFESSIONAL RESPONSIBILITY

Real property transactions generate a disproportionately great number of malpractice claims, perhaps in part because investigations are conducted in hindsight. Absent a client's informed consent to an alternative arrangement, attorneys representing clients must maintain the confidences and secrets of the client and exercise "independent professional judgment" on their behalf, judgment free of self-dealing and dual representation. This requires that no representation of a client be undertaken if it will be directly adverse to the interest of another client unless (1) the attorney believes reasonably that the representation otherwise prohibited will not adversely affect the relationship with the other client and (2) each client consents after consultation and disclosure of all relevant facts. See Am. Bar Assn., Model Code of Profess'l Responsibility (first adopted in 1969 and the basis for several states' ethical rules); Disciplinary Rule (DR) 5-105(A)-(C)), and Canons 4 and 5 (EC 4, 5-1). Self-dealing is prohibited absolutely, and there are, moreover, reasonable arguments for abolishing dual representation outright.

The structure of a real estate transaction requires constant communication — a virtual monologue with the inexperienced client and communication about new aspects of the transaction with experienced ones, from the engagement letter forward. This is so because the transaction culminates in a closing, or receipt of escrow papers, and a client should

never experience any surprises when sitting at the closing table. In order to satisfy themselves about potential problems, levels of knowledge, and conflicts of interest in the transaction, attorneys need to assess existing representations for conflicts — their own, their partners', and their firms' — both before and after undertaking the representation. When conflicts are reasonably foreseeable, and before they arise, attorneys have a professional obligation to avoid them, even if that means withdrawing from the representations and the transactions.

Moreover, because attorneys often represent developers and mortgage lenders on a continuing basis, and vendors and purchasers of property on an irregular basis, they must diligently watch for potential conflicts of interest.

Enforcement of these rules is uneven, but that is no reason to ignore the precepts in them. They should be incorporated in an attorney's ongoing duties. Some believe that every real estate transaction should involve two attorneys, one for the vendor and another for the purchaser, but in the many transactions in which the purchase price is not paid in cash but is instead financed by a third-party lender, at least one other party needs representation. In fact, a third-party lender seldom goes unrepresented, and indeed in some regions its attorney is often the only attorney present, handling the closing of the title as well as the lending transaction. This raises an interesting issue: Does an attorney violate any rule of professional responsibility by representing both parties to the transaction? No. Merely representing both parties, except in negotiating the contract of sale, does not violate any rule so long as the attorney meets the requirements of consultation with the client See *ibid.*, DR5-105(C).

In the following short examples, assume that the attorney has checked and found no past conflicts of interests in the representations of two parties, vendor and purchaser.

Examples

Example 1a

Once hired by one party, could an attorney obtain a written consent from both parties at closing, and satisfy DR5-105?

Explanation

No. The timing shows conclusively that the parties consented too late in the transaction.

Example 1b

Could an attorney have obtained the same consent at the execution of the contract of sale?

Explanation

No again. Why? Because the rule requires that there be a consultation. Simply signing the consent form does not meet that requirement.

Example 1c

What sort of consultation is required? Suppose an attorney once hired by one party consulted with both together and explained the potential problems to them. Is that sufficient?

Explanation

Maybe not. A separate meeting with each client may be required. When one party is first represented, there must be a separate meeting with her to obtain her consent to multiple representation; with her consent, then a separate meeting with the purchasers is in order.

Example 1d

If the vendor and the purchaser in the prior examples proceed to close the transaction, suppose the attorney does not attend and instead sends her very competent paralegal. Is she violating the canons or is she encouraging the unauthorized practice of law?

Explanation

Yes is the answer to both questions in some states like South Carolina but not in most states (see, e.g., North Carolina Ethics Opin. 9 (02 FEO 9), issued Jan. 24, 2003 (a nonattorney assistant may identify the documents at the closing, even with no attorney present); and N.C. Gen. Stat. §84-2.1 (defining the practice of law)).

Example 1e

Suppose the vendor and purchaser ask the attorney at the closing to act as an escrow agent for a fixture on the property when the parties disagree on whether it was sold. Is this allowed?

Explanation

Some cases make the agent only liable to carry out the terms of the escrow, so they had better be clear and in writing. Other cases say that the agent is the fiduciary of each party to the escrow.