CADWALADER

What Comes Next?

January 31, 2023

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A Tumultuous 2022 for CRE and What Comes Next

January 31, 2023

This *Law360* article examines some key 2022 market trends in the commercial real estate industry and looks ahead to 2023.

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Breaking Up Is Hard to Do: Partition and Possible Land Mines (or What to 'Mind') for Lenders and Tenants-in-Common

January 31, 2023

Can you play nice and share a piece of real estate? Sharing is hard enough, but imagine jointly owning an investment property with your brother when he decides that he would like to sell and then retire in Hawaii. While your brother would like to cash out his investment for the sun and sand, you live in the building, operate your business in the ground floor commercial space and never want to sell the building that you inherited from your parents. What if you cannot amicably resolve the dispute?

A partition action provides a remedy to any person or entity who co-owns property with another (not in the form of an LLC or partnership) and who wishes to segregate and terminate common ownership interests in the same parcel of property. Partition actions are a unique option of last resort when diverging interests are at odds and, if possible, should be avoided with proper real estate planning. Under N.Y. Real Prop. Acts. Law ("RPAPL") § 901, a partition remedy is available to any person who is a joint-tenant or tenant-in-common under New York real property law. A tenancy-in-common and joint tenancy is a form of ownership where two or more parties, as co-tenants, own directly, undivided interests in real property. Ideally, the co-owners of the property will have planned in advance, through a written agreement (a TIC Agreement), how to effectuate a division or sale of the property, or will amicably come to an agreement as to how to fairly divide or to sell the property. The distinction between a joint tenancy and a tenancy-in-common is that, in a joint tenancy, the survivor of the property inherits the interest of the other, while in a tenancy-in-common, the interest will pass through to the issue, heirs or devisee of the decedent tenant-in-common.

Where an agreement or voluntary disposition is not possible, the parties must file a partition action to obtain a ruling from a court to unravel the co-ownership interests that are at odds. There are two ways to effectuate a partition of real estate in New York: (i) a partition in kind, which physically divides the property so that each party owns a portion of property as the sole owner, and (ii) a partition by sale, where the property at issue is sold at auction and the co-owners divide the proceeds in proportion to their ownership rights. In New York, a partition by sale is far more common because the property in dispute typically cannot be physically or equitably divided, as many properties consist of a single tax lot with one improved structure, and even seemingly similar properties, like condominium units in the same building, will often have differences (*i.e.*, views, layouts) that make division impractical.

While joint ownership and the tenant-in-common structures are common, they do present certain risks for the individuals involved and any potential mortgage lenders, including the risks posed by a partition action, unresolved disputes between TIC Owners, and owners losing their equity in the property. If a tenant-in-common property is partitioned into multiple parcels, the lender, as long as all tenant-in-common owners are party to the loan, will retain its lien on each parcel between its borrowers and guarantors, but each parcel would no longer be operated in a uniform fashion under common management. The value of each individual parcel may also vary or be less than its original appraised value. Similarly, if the mortgaged property is subject to a partition action and subject to a court-ordered sale, the proceeds of the sale may be less than the lender's loan or expected return and increase the risk of disruption of the property's performance during the term of the legal proceedings, particularly if the tenants in common are not cooperating in management.

For lenders, it is undeniable that tenancy-in-common ownership structures present obstacles, although many of the obstacles can be mitigated through the implementation of comprehensive tenancy-in-common agreements and well-crafted loan documents. Because of the significant consequences to the collateral if the property were partitioned, a lender typically will require the co-tenant borrowers to waive their right to partition for the term of the loan. The waiver of the right to partition should be affirmed and codified in the tenant-in-common agreement, or similar agreement if applicable, and affirmatively waived in the loan documents. As added precaution when drafting loan documents, a breach by the borrower of its covenant to waive its right of partition should not only be a default under the loan documents but also included as a non-recourse carve-out, such that a violation would give rise to recourse liability against both the borrower and any guarantor. In addition, the waiver of the right to partition should be filed of record in the applicable recording office to reflect that the interests under the agreement are subordinate to the lender's mortgage. The lender should also require that the borrower's attorney provide a legal opinion addressing enforceability of the partition waiver contained in the tenant-in-common agreement and the loan documents.

In most cases, all co-owners will be party to the loan documents and both individually and jointly liable for the obligations to repay under the loan documents. This requirement is needed due, in part, to RPAPL §929, which provides that "after actual partition the lien of a creditor having a lien on an undivided share or interest in the property, who is or is not made a party, shall attach only to the share or interest assigned to the party upon whose share or

interest the lien attached…" Having all co-owners as signatories to the loan documents provides added protection for the lender to ensure they have a lien on the entire collateral, even if partitioned.

An additional issue to be addressed is how the interests are separated if one party agrees to buy the other out in a settlement of a partition action. If the subject property is encumbered by a loan and all TIC Owners are jointly liable, although the co-owners may agree on the terms and price for one individual to remain an owner of the property and purchase the equity interest of the departing person, the agreed sale would result in a default under the loan, unless the lender provides consent for the separation of ownership. If the lender does not consent, the TIC Owners are still both jointly liable to the lender under the terms of the loan and responsible for repayment of the loan, and can be sued in a foreclosure action after a default under the loan. The departing co-owner technically has no connection to the property after the partition (if an equity purchase) but is still obligated under the loan, unless otherwise released from its obligations and guaranty under the loan by the lender.

To mitigate the lender's risk of the intertwined financing of TIC Ownership, the lender should take particular care in reviewing the TIC agreement and prevent or limit resale of the TIC Ownership interests under the loan documents. The loan documents will typically contain transfer provisions restricting change of ownership (guided by a threshold percentage of ownership change) without the lender's consent, or even a "due on sale" provision that prohibits TIC Ownership interests from being sold without the lender's consent. In cases where TIC Owner can transfer their interests, lenders obligate that the new TIC Owner assume the obligations and liabilities of the departing TIC Owner under the loan documents.

For joint owners of real estate, there are also many risks and potential abuses of the partition action that often target owners that are unsophisticated in real estate matters and/or economically disadvantaged. Through legislation, many states enacted the Uniform Partition of Heirs Property Act ("UPHPA"). Since introduction of the UPHPA in 2010, versions of the UPHPA have been enacted in 21 states, including New York, and similar bills are currently being considered in other states. In the State of New York, the UPHPA, codified in RPAPL § 993, the forced sale of inherited property goes through a different process than the typical partition process, which is designed to help families that own "heirs property" as tenants-in-common that have been targeted by real estate opportunists looking to acquire property at below market prices. "Heirs Property," as defined under RPAPL § 993, "means real property held in tenancy-in-common which satisfies all of the following requirements as of the filing of a partition action: (i) there is no agreement in a record binding all of the co-tenants which governs the partition of the property; (ii) any of the co-tenants acquired title from a relative, whether living or deceased; and (iii) any of the following applies: (A) twenty percent or more of the interests are held by co-tenants who are relatives; (B) twenty percent or more of the interests are held by an individual who acquired title from a relative, whether living or deceased; (C) twenty percent or more of the co-tenants are relatives of each other; or (D) any co-tenant who acquired title from a relative resides in the property." Before New York enacted UPHPA, partition law in the State of New York left co-tenants' heirs subject to being taken advantage of by creative real estate investors. In New York, under the UPHPA, once the court classifies the inherited property as Heirs Property, the other co-owners are given due process protections such as notice, appraisal, the opportunity (or right of first refusal) to buy out the share of the other co-owners who filed an action for partition and if the other tenants-in-common chose not to exercise their right and a sale is required, a commercially reasonable sale supervised by the court to ensure all parties receive their fair share of the proceeds at market value.

When property is owned as a tenancy-in-common, particular care should be exercised to address this nuanced ownership structure to protect against and mitigate the risks attendant to common law and statutory rights of partition.

Title (Coverage) Not Available

January 31, 2023

Two recent decisions concerning title insurance illustrate that an insured's negligence can result in an exclusion from coverage and that title insurers generally do not owe a fiduciary duty to their insureds.

In *First Nat'l Bank of Izard Cnty. v. Old Republic Nat'l Title Ins. Co.*, the Court of Appeals of Arkansas (the "Court") denied a rehearing where a title insurance company refused to defend an insured bank and denied the insured bank's claim for coverage where another party held an interest superior to the bank's mortgage in connection with a foreclosure. The Court affirmed the circuit court's order of summary judgment in favor of Old Republic National Title Insurance Company ("Old Republic") on appeal by First National Bank of Izard County (the "Bank").**[1]**

In connection with the dissolution of a partnership, two partners, Helen and George Bartmess (each individually, a "Bartmess" and collectively, the "Bartmesses"), sold their business interests to John Hardy ("Hardy"). Hardy obtained a loan from the Bank to effectuate the purchase.**[2]** One of the assets transferred in the sale was a 377-acre tract of land (the "Phillips Corner Property"). The terms of the sale were set forth in two documents: (1) an LLC Membership Interest Purchase Agreement (the "Purchase Agreement"), which set forth the terms and conditions of the sale and (2) a Memorandum of LLC Membership Interest Purchase Agreement Affecting Real Estate and Rights Therein (the "Memorandum").**[3]** The Purchase Agreement contained a provision that created a reversionary interest in the Phillips Corner Property back to the Bartmesses under certain instances of noncompliance. While the Memorandum did not explicitly disclose the reversionary interest in the Phillips Corner Property, it indicated that: (1) the document affected rights in real estate; (2) the Memorandum would be filed in the mortgage and conveyance records for Izard County, Arkansas; and (3) a legal description of the Phillips Corner Property was attached to the Memorandum.**[4]**

The Bank made two loans to Hardy related to the Phillips Corner Property to facilitate the transaction, and the Bank was on notice of the purpose of the Memorandum.**[5]** The Bank issued a $55,000 loan (the "55k Loan") secured by a mortgage on the Phillips Corner Property dated February 12, 2009, and, five months later, a $155,000 loan (the "155k Loan"; together with the 55k Loan, the "Loans") also secured by a mortgage on the Phillips Corner Property.**[6]** Old Republic issued separate title insurance policies to the Bank insuring that (the policies for the Loans, collectively referred to as the "Policies"), which Policies insured the Bank's mortgage liens were superior to other claims on the Phillips Corner Property.**[7]** In connection with the closing of the 55k Loan, an employee of the Bank who served as witness and notary took possession of the documents, including the Memorandum and the Bank's mortgages, and mailed them to the county clerk for recording. The employee included a note that stated "record in this order" on the first document and placed a number on the following documents to indicate the correct order for recording.**[8]** On February 23, 2009, the county clerk recorded the documents, filing the Memorandum four minutes before the Bank's mortgages encumbering the Phillips Corner Property. The clerk returned the recorded documents to the Bank employee, who did not check to confirm they were recorded in the correct order. The Bank closed on the 155k Loan on July 8, 2009, and Old Republic issued a title policy in connection with the closing, which indicated the only prior lien on the Phillips Corner Property was the 55k Loan without reference to the Memorandum.**[9]** Hardy went into default on the Loans in 2015, and the Bank initiated a foreclosure action. Bartmess asserted a superior interest in the Phillips Corner Property pursuant to the Memorandum.

Old Republic refused to defend the Bank and denied the Bank's coverage under the Policies. The Bank subsequently filed suit against Old Republic, claiming: (1) breach of the Policies for failure to provide coverage; (2) failure to defend the Bank in the foreclosure; and (3) failure to pay the Bank's damages due to the loss of its security interest in the Phillips Corner Property.**[10]** The Policies contained a provision that certain matters were expressly excluded from coverage and Old Republic would not be responsible for loss or damages, costs, attorneys' fees or expenses arising therefrom, including for "[d]efects, liens, encumbrances, adverse claims or other matters: (a) created, suffered, assumed, or agreed to by the Insured Claimant" (the "3(a) Exclusion").**[11]**

Old Republic asserted in its motion for summary judgment that: (1) the terms of the Memorandum and the LLC Purchase Agreement were disclosed to the Bank and were in the Bank's possession prior to closing, and (2) the Bank's handling of the documents for recording resulted in the Memorandum being recorded ahead of the mortgages. The circuit court determined that Old Republic correctly applied the 3(a) Exclusion because the Bank "created, suffered, assumed or agreed to" the title defects, where the term "suffered" is equivalent with "permitted" and "implies a power in the insured to prohibit the act giving rise to the defect."**[12]** The Court held that the circuit court did not err in concluding that willful intent on the part of the Bank was not required for the 3(a) Exclusion to apply where the Bank had the power to prohibit the Memorandum from having priority over its mortgages, thus Old Republic properly denied coverage under the Policies.**[13]**

Similarly, in *Murphy v. Commonwealth Land Title Insurance Company*, the United States District Court for the Eastern District of New York (the "District Court") granted summary judgment in favor of the defendant insurance companies, Fidelity National Financial, Inc. ("FNF") and Commonwealth Land Title Insurance Company ("Commonwealth"), a wholly owned subsidiary of FNF, where Commonwealth and FNF properly denied the plaintiff's claim for coverage because it fell under certain exclusions to the plaintiff's title policy.**[14]** The plaintiff, Edward Murphy ("Murphy"), financed the purchase of a home in Sag Harbor, New York (the "Sag Harbor Property"), which was secured by a mortgage in favor of Washington Mutual Bank ("WAMU") as lender.**[15]** Commonwealth issued a title policy to Murphy in connection with the purchase of the Sag Harbor Property, subject to certain exclusions, including: (1) loss or damage arising by reason of the mortgage; (2) all encumbrances attached to or created subsequent to the date of the policy (June 4, 2002); and (3) all matters "created, suffered, assumed or agreed to" by the insured (collectively, the "Exclusions").**[16]**

WAMU initiated foreclosure proceedings against Murphy after he failed to pay the mortgage. A foreclosure judgment (the "2008 Foreclosure") was entered and in November 2008, the Sag Harbor Property was thereafter sold to JPMorgan Chase Bank ("JPMC"), as successor to WAMU. In October 2009, JPMC sold the Sag Harbor Property to an individual (the "Purchaser") who was issued a title insurance policy from Fidelity National Title Insurance Company ("FNTIC"), which, like Commonwealth, is a wholly owned subsidiary of defendant FNF.**[17]**

The appellate court set aside the 2008 Foreclosure judgment due to improper service of process in April 2015. Murphy then sued JPMC and the Purchaser seeking damages for wrongful foreclosure and an order vacating the Purchaser's deed to the Sag Harbor Property (the "2016 Action"). FNTIC accepted the Purchaser's claim for coverage related to the 2016 Action, while Commonwealth denied coverage to Murphy related to the 2016 Action because the suit arose out of the default on his mortgage, which commenced after the date of the title insurance policy.**[18]** In February 2019, the Suffolk County Supreme Court found that the Purchaser was a bona fide purchaser and dismissed Murphy's claim for wrongful foreclosure.**[19]**

Murphy brought suit against Commonwealth and FNF alleging breach of contract, violations of the New York General Business Law (the "GBL") § 349, and breach of fiduciary duty. The District Court denied the breach of contract claim, finding that Commonwealth properly declined coverage under the Exclusions because Murphy brought the foreclosure upon himself and the mortgage was subsequent to the deed and title insured by Murphy's policy.**[20]** Further, because there was no breach of contract, the District Court concluded that a conflict of interest which would require appointment of independent counsel pursuant to GBL § 349 did not exist, as Commonwealth had no obligation to defend Murphy in the 2016 Action in the first instance.**[21]** Likewise, the District Court held that Murphy's breach of fiduciary duty claim failed as a matter of law, because (1) insurance companies do not owe a fiduciary duty to their insureds absent a special relationship, (2) a special relationship could exist between an insurance company and its insured where an insurer has an obligation to defend the insured in a liability claim; however, here the District Court ruled that Commonwealth had no obligation to defend Murphy in the 2016 Action by virtue of the Exclusions, and (3) Murphy failed to allege any special circumstances that would give rise to a fiduciary relationship.**[22]**

These decisions are potentially pervasive, extending exclusions from title insurance coverage to more than just intentional actions but to negligent actions as well. While certain circumstances may invoke different obligations, *Murphy v. Commonwealth Land Title Ins. Co.* also demonstrates the standard scope of the relationship between insurer and insured. The outcomes of these decisions stress the significance of an insured's understanding of the limitations to their coverage and how their actions, intentional or unintentional, may impact such limitations. Of note, in addition, is that it is more typical for title insurance companies to take possession of and be responsible for the recordation of documents at closing. The decision in the Old Republic case probably would have been different if the title company was the party responsible for recordation. While local customs and practices vary throughout the country, parties should be wary of the impact that assuming responsibility for recordation may have on their coverage.

[1] *First Nat'l Bank of Izard Cnty. v. Old Republic Nat'l Title Ins. Co.*, 2022 Ark. App. 440, 1 (2022), reh'g denied (Dec. 14, 2022)

[2] *First Nat'l Bank of Izard Cnty*. at 2.

[3] Id.

[4] Id.

[5] Id. at 10.

[6] Id. at 3.

[7] *First Nat'l Bank of Izard Cnty*. at 3.

[8] *First Nat'l Bank of Izard Cnty*. at 4.

[9] Id.

[10] Id. at 5.

[11] *First Nat'l Bank of Izard Cnty*. at 9.

[12] Id. at 9.

[13] Id. at 10-11.

[14] *Murphy v. Commonwealth Land Title Ins. Co.*, 2022 WL 3347223 (E.D.N.Y. Aug. 12, 2022).

[15] *Murphy v. Commonwealth Land Title Ins. Co.*, at 1.

[16] Id.

[17] Id.

[18] Id.

[19] Id. at 2.

[20] *Murphy v. Commonwealth Land Title Ins. Co.*, at 3.

[21] *Murphy v. Commonwealth Land Title Ins. Co.*, at 3.

[22] Id. at 4.

Hedging in UK Real Estate Finance Transactions - Part 1

January 31, 2023

By **Assia Damianova**
Special Counsel | Securitization & Asset Based Finance

We previously we took an **initial look** at hedging in real estate financing transactions. In this article, we discuss the various hedging products that we commonly see in real estate financings.

Common forms of hedges

Interest rate derivatives

In the UK, interest rate hedging on real estate debt is relatively common and may be undertaken at (i) an asset level or (ii) a portfolio level. Hedging a floating-rate loan via an interest rate cap or swap is perhaps the most common way of managing interest rate risk.

An ***interest rate cap*** will set a maximum rate that the reference rate of the loan can reach before the Borrower is compensated. This means that the Borrower pays a floating rate (reference rate plus margin) up until a predetermined threshold level (the "strike"), but when the reference rate surpasses the strike, the Hedge Counterparty will pay out the difference between the actual reference rate and the strike. The Borrower can thus limit their interest rate risk at a predetermined maximum level, and their interest rate costs cannot then exceed the loan margin plus the strike rate of the cap. In return for taking interest rate risk above the strike, the Hedge Counterparty will charge un upfront premium. Given such an upfront payment, the Borrower will want to ensure that in the derivatives documentation:

- a number of standard triggers in the ISDA documentation are disapplied with respect to the Borrower (as it has fulfilled its payment obligation upfront), and
- there are sufficient triggers linked to the credit-worthiness of the Hedge Counterparty that is the cap provider.

An ***interest rate floor*** will set a pre-agreed strike rate that is below the current reference rate. Borrowers with such a product will get compensated by the Hedge Counterparty should the reference rate fall to a level below the strike.

An ***interest rate collar incorporates*** both a cap and a floor, protecting against substantial volatility in both directions.

An ***interest rate swap*** (linked to a floating rate facility agreement) would permit the Borrower to pay a fixed rate to the Hedge Counterparty with the floating payments coming from the Hedge Counterparty, thus allowing the Borrower paying a floating IBOR rate under their facility agreement to protect against rising interest rates. (Conversely, if the base rate is lower than the fixed rate, the Borrower will owe the Hedge Counterparty the difference.) Unlike a cap, the market value of an interest rate swap may vary significantly, so in the event of early termination, or a partial unwind to avoid over-hedging under the facility agreement, the Borrower will have to pay the negative market value (and conversely, the Hedge Counterparty will have to pay the positive market value − for example, when the market value for the remaining term of the swap is higher than the fixed rate of the swap).

Currency hedging

Foreign exchange forward contracts (FX forwards) permit the Borrower with a cashflow or outflows in different currencies to buy (or sell) one currency by paying with (or selling) a different currency at a certain point in the future. The benefit for the Borrower is having a known value of the exchange rate that will apply to a future payment when managing its property portfolio.

A ***cross-currency swap*** works in a similar way to interest rate swaps. The Borrower will exchange one currency into another at the then-current market rate. At the maturity on the swap, the Borrower will be able to exchange back to the original currency at the same exchange rate, thus eliminating any foreign exchange risk on the relevant asset.

In next month's *REF News and Views*, we will continue with our discussion on hedging in real estate financing transactions by discussing the frequently negotiated tension points between the facility agreement and the Hedging Agreement.

Cadwalader Named a ‘Hospitality Group of the Year’ by Law360

January 31, 2023

For a second consecutive year, Cadwalader’s Real Estate team has been honored by *Law360* as a “Hospitality Group of the Year.”

Based on an interview last week with Real Estate Finance head Bonnie Neuman, a *Law360* practice profile credits the Cadwalader team with playing “a vital role in helping to reshape an industry hit hard by the pandemic” and credits the firm for leading "the charge on financing some of the hospitality sector’s biggest and most high-profile projects.”

Several of our prior-year client representations are highlighted, including our work advising the lenders in high-profile deals including the $1.04 billion acquisition financing for CorePoint Lodging, a nearly $1.2 billion acquisition financing of 111 WoodSpring Suites properties, a $1.2 billion mortgage loan to acquire extended stay properties, a $3.15 billion single-borrower securitized financing secured by the leased-fee interest in Aria Resort & Casino and Vdara Hotel and Spa in Las Vegas, the $217.5 million refinancing of the Gurney’s Resort and Seawater Spa in the Hamptons and a $90 million construction loan for the development of Great Wolf Lodge and Waterpark Resort, as part of our long-standing relationship with Great Wolf.

As Bonnie notes, “We’re fortunate to be able to work with nearly all the hotel brands, as well as the borrowers and owners and operators, and having those connections and the ability to understand their various needs and the ways in which the parties need to work together is very valuable.”

You can read the practice profile **here**.

Recent Transactions

January 31, 2023

Here is a rundown of some of Cadwalader's recent work on behalf of clients:

- Represented the lender in a $72 million mortgage loan to refinance a 154-room full-service hotel located in Charleston, South Carolina.
- Represented the lender in a mortgage loan secured by a Marriott-franchised hotel located in downtown Birmingham, Alabama.
- Represented the administrative agent and lender in connection with a $430 million loan modification due to the sponsor’s retention of a third-party asset manager.
- Represented a private equity fund in connection with a secured equity investment in a venture for the construction of a luxury apartment complex in southern Florida.