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Be Careful About What You Think You Know: A Little-Known Loophole in New Jersey's Statute of Frauds Exempts Short-Term Leases and Lease Extensions

It is a well-established principle of law that, in most circumstances, documents conveying interests in real estate – such as purchase agreements, leases, easements and mortgages – are subject to the Statute of Frauds and therefore must be established in writing. In New Jersey, however, it is not as well known that leases of real estate for terms of less than three years are **not** required to be in writing. *N.J.S.A. 25:1-12*. The right to contract orally also applies to the extension of leases for terms of less than three years and to the assignment of leases with terms (or remaining terms) of less than three years. (See *Stark v. National Research & Design Corp.*, 33 N.J.Super. 315 (App. Div. 1955) (regarding the oral assignment of a lease with less than three years remaining in the term).

Given the continuing uncertainty in the commercial real estate market, the climate is ripe for players on all sides of a lease transaction to take advantage of this loophole in the statute. For example, tenants who

have empty or partially empty premises may be searching for potential subtenants or assignees. Other tenants may want to remain in their current space at below-market rent for a few months after the expiration of their current leases. Landlords may be trying to fill empty premises or favoring short lease extensions to keep their premises filled and maintain cash flow.

Whether it be during telephone conversations between principals of the parties or the constant flow of e-mail among the parties and their brokers or attorneys, there arises the possibility that one side will take a seemingly innocuous discussion about the proposed terms of a lease, lease extension or assignment and rely upon the discussion as constituting a mutual agreement for a leasehold interest of less than three years. With that in mind, parties negotiating shorter-term leases, lease extensions, and subleases or assignments should be cautious and keep in mind the following practice pointers:

- At the inception of negotiations, make it clear both verbally and in writing that any agreement between the parties must be reduced to a formal written contract executed by both parties. Also, make it clear that

brokers and attorneys cannot agree to the terms of a contract on your behalf.

- As always, be cognizant of the words you use during negotiations, and follow-up telephonic and in-person negotiations with an e-mail documenting what transpired and reiterating that the negotiations do not constitute an oral agreement between the parties.
- Be aware of the other party's responses to your comments and whether they take, or intend to take, actions that evidence that they are relying on the negotiations as constituting an oral contract. For example, if a potential tenant engages an architect to draw up plans for the improvement of the premises that is the subject of discussions, then the potential tenant may later state that it engaged such contractor solely because it believed that the landlord had orally agreed to a lease and that it was relying on that fact.
- For a potential long-term tenant or a potential purchaser of rental property, it would be prudent to ask the landlord or seller, as applicable,

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whether they have discussed any short-term leases (or extensions) with new or existing tenants. If the seller answers in the affirmative, it may be prudent to require an indemnity to cover any risk associated with a tenant claiming to have an oral lease.

- Landlords should consider whether, at the outset of discussions, they should require a potential short-term tenant or an existing tenant who is interested in an extension of less than three years to sign a pre-negotiation agreement that would make it absolutely clear that no agreement will be reached unless and until a definitive agreement is signed between the parties.

Please feel free to reach out to one of the members of our Real Estate Practice Group at any point during your consideration of a short-term lease, lease extension or assignment, to discuss ways to help avoid the potential pitfalls presented by this loophole in New Jersey's Statute of Frauds. We are also available to help in formulating appropriate pre-negotiation agreements and discussing how to combat another party's claim that you entered into an oral lease.

Comprehending the Incomprehensible: New Jersey's Controlling Interest Transfer Tax

The Controlling Interest Transfer Tax

Since 2006, purchasers of a "controlling interest" in an entity that directly or indirectly owns commercial real property located within New Jersey have been subject to a special tax known as the "Controlling Interest

Transfer Tax," or the "CITT." N.J.S.A. §54:15C-1 and N.J. Admin. Code §§18:16A-1.1 to 1.5. The CITT is calculated according to one of the following two methodologies, depending on whether the entity in which ownership interests were purchased owns assets other than commercial real property (such as personal property). If the entity owns only commercial real property, then the CITT is equal to 1% of the consideration paid for the purchased ownership interests. However, if the entity owns, directly or indirectly, an interest in any assets other than commercial real property, then the CITT is equal to 1% of the equalized assessed value of the commercial real property (prorated with respect to the percentage of ownership of the entity purchased).

The CITT was enacted as a companion to the 1% tax imposed on the direct transfer of classified commercial real property for a consideration in excess of \$1 million. Ostensibly, the purpose of the CITT was to prevent taxpayers from avoiding the 1% tax on direct transfers, by instead transferring interests in the entity owning the real property.

The CITT can be substantial, especially in relation to the purchase price. For example, assume that a limited liability company ("LLC") owns commercial real property with an equalized assessed value of \$50 million that is subject to a mortgage of \$45 million. The LLC also owns assets of insignificant value in addition to the commercial real property, and thus, upon a sale of a "controlling interest" of the LLC's membership interests, the CITT is required to be calculated based on the equalized assessed value of the commercial property rather than the

consideration paid for the interests. Assume a purchaser pays \$5 million (the net value of the real property) for 100% of the membership interests. That purchaser would be subject to a CITT of \$500,000 (1% of \$50 million, the equalized assessed value of the real property), constituting 10% of the purchase price paid for the membership interests. Note that, if the mortgage were large enough, the CITT could actually exceed the purchase price of the interests.

What Is a "Controlling Interest"?

Despite the substantial nature of the tax, the vagaries of the CITT statute and regulations leave its application uncertain, including with regard to the meaning of the term "controlling interest." Under the statute, "controlling interest" means, in the case of a corporation, more than 50% of the total combined voting power of all classes of stock of the corporation and, in the case of an entity taxed as a partnership (such as most multi-member LLCs), more than 50% of the beneficial ownership of the commercial real property of the partnership.

Consistent with its apparent purpose of preventing taxpayers from avoiding the 1% tax on direct transfer of classified commercial property, the CITT clearly applies to a purchase of 100% of the interests in an entity owning commercial real property. In such a case, there is no doubt that a "controlling interest" has been transferred. However, ambiguity arises with more complex transactions. For example, assume that a purchaser of voting stock already owns 49% of the voting stock of a corporation and plans to purchase only an additional 2%. This transaction would thus effectuate a shift in control of the

corporation to the purchaser. Is this a transfer of a controlling interest? Similarly, if a purchaser already owns a controlling interest in a corporation, is the acquisition of an additional interest subject to the CITT? While there is no published guidance from the Division of Taxation on these questions, the answers may hinge on whether the acquisition of the interests in question (i.e., the interests currently held by the purchaser and the additional interests to be acquired by the purchaser) were related transactions that occurred within six months of each other. Another question arises in the context of preferred stock, which may carry contingent voting rights. Specifically, does the right to control the company in only certain cases constitute a “controlling interest”?

The law is even less clear with regard to partnerships (and LLCs taxed as partnerships). As discussed above, in the context of a partnership, a “controlling interest” means more than 50% of the beneficial ownership of classified real property of the partnership. The statute does not define “beneficial ownership,” and the regulations promulgated by the Division of Taxation are nearly inscrutable. To wit: “‘Beneficial ownership’ means ownership of tangible or intangible property by a person or entity that does not have legal title to the property but has ultimate control of the property in regard to the transfer of a controlling interest in class 4A commercial real property between that person or entity and a separate legal entity.”

Thus, the regulations merely shift the inquiry from the definition of “beneficial interest” to the definition

of “ultimate control,” which the regulations leave undefined. Is “ultimate control” signified by an affirmative right to sell the property or is veto power sufficient? In addition, as in the case of corporations, it is unclear how to treat already-owned interests and contingent voting rights.

Due to the short period of time since the enactment of the CITT, the New Jersey courts have yet to interpret the statute and regulations. With all these questions left unanswered, guidance from the courts is hopefully not far off. Until then, however, investors and other purchasers of interests potentially subject to the CITT should proceed with extreme caution and are welcome to contact any of the members of our Real Estate Practice Group to discuss the structuring of proposed transactions and potential CITT consequences.

Massachusetts Court Sets Aside Foreclosures – Will This Decision Impact Foreclosures in New York and New Jersey?

The Massachusetts Supreme Judicial Court’s decision in *U.S. Bank National Association v. Ibanez*, No. SJC-10694, 2011 Westlaw 38071 (Mass. January 7, 2011) has caused a firestorm in the world of residential and commercial mortgage-backed securities. In this consolidated case, the Court invalidated two residential foreclosure sales because the Court found that U.S. Bank National Association (“U.S. Bank”) and Wells Fargo & Company (“Well Fargo” and together with U.S. Bank, the “Trustees”) could not show that they were the holders of the subject mortgages at the commencement of foreclosure proceedings. The Court held that without proof of a proper assignment

prior to the commencement of foreclosure proceedings, the Trustees for the REMIC trusts purporting to hold the mortgages could not rely upon assignments after the fact to cure the deficiency.

Massachusetts allows nonjudicial foreclosure of mortgages by exercise of the statutory power of sale. Because a mortgage holder may foreclose without immediate judicial oversight, under Massachusetts law the terms of the power of sale in the applicable mortgage must be strictly followed. “If [the mortgage holder] fails to do so, there is no valid execution of the power, and the sale is wholly void.”¹ The statutory power of sale can be exercised by the mortgagee or his executors, administrators, successors or assigns.² Under the plain language of the statute, the Trustees only had the authority to exercise the power of sale if they could establish that they were the assignees of the subject mortgages at the time of the notice of sale and the subsequent foreclosure sale.³

To support their claim to be the holders of the mortgages at the time of the notice of sale, the Trustees proffered, among other documents, mortgage assignments executed in connection with the establishment of the REMIC trusts by the prior holder of the mortgages “in blank” (i.e., without specifying to whom the mortgages were to be assigned). The Court quickly rejected the assignments in blank as invalid, stating that “a mortgage that does not name the assignee conveys nothing and is void; [Massachusetts does] not regard an assignment of land in blank as giving legal title in land to the bearer of the assignment.”⁴

Although each of the Trustees purported to hold its mortgage through a series of assignments, neither could establish that it was the holder of record of its respective mortgage. The Trustees asserted ownership of the mortgages pursuant to the terms of their securitization documents.⁵ The Court rejected the securitization documents as insufficient evidence that the Trustees were present holders of the subject mortgages. While an assignment of mortgage need not be in recordable form at the time of the notice of sale or subsequent foreclosure sale, the Court specifically noted the following:

Where a pool of mortgages is assigned to a securitized trust, the executed agreement that assigns the pool of mortgages, with a schedule of the pooled mortgage loans that clearly and specifically identifies the mortgage at issues as among those assigned may suffice to establish the trustee as the mortgage holder.⁶

Because the Court found that the Trustees failed to establish that they held the mortgages at the time of the notice of sale, the Court held that they did not have the authority to foreclose under the power of sale.

The *Ibanez* decision reinforces the fundamental requirement that a trustee of a REMIC trust must obtain a valid assignment of all mortgages and underlying loan documents in the pool prior to commencing foreclosure proceedings or exercising a power of sale against a particular defaulted mortgage loan. The availability of non-judicial foreclosure in Massachusetts allowed conditions to arise in which the Trustees were not the present holders of the mortgage, rendering the foreclosure sales invalid. However,

in states requiring judicial oversight of foreclosure, such as New York⁷ and New Jersey, the *Ibanez* decision merely confirms standard foreclosure practices.

In New York and New Jersey, judicial oversight of mortgage foreclosure requires that the foreclosing lender submit for the court's review the loan documents, including all written assignments of mortgage. Under New Jersey law, a mortgage assignment must be in writing⁸ and may be recorded in the county recording office, although the failure to record an assignment of mortgage does not affect the validity of the assignment.⁹ If the plaintiff is not the original mortgagee, the name of the original mortgagee and a recital of all assignments in the chain of title must be included in the foreclosure complaint.¹⁰ In order to obtain a judgment in foreclosure, the plaintiff must produce the original or a certified true copy of the mortgage, evidence of indebtedness, assignments, and any other original document upon which the claim is based.¹¹

Under New York law, an assignment of mortgage need not be in writing but may be accomplished by delivery of the mortgage with the intention of assigning same. The assignment must be complete at the time a foreclosure action is initiated and the assignment to the foreclosing plaintiff is recited in the complaint.¹² Where a written assignment is executed subsequent to the initiation of the foreclosure action, and there is no proof of earlier file delivery, the action will be dismissed.¹³ It should be noted, however, that prior to the execution of a foreclosure deed to the purchaser at the foreclosure sale, any written assignment of the

mortgage must be filed with the clerk or, if same is in recordable form, the assignment must be recorded in the county where the property is located.¹⁴

While the *Ibanez* decision has caused a firestorm in some residential and commercial securitization circles, the case merely confirms the standard practice that a foreclosing mortgage holder must have its documentation in place prior to commencing foreclosure proceedings. While assembly of such documentation may prove to be a challenge to trustees of REMIC trusts that were created under more lax underwriting and record-keeping practices, it should have no significant impact on foreclosure practices in New York and New Jersey, which have always mandated that a foreclosing plaintiff establish that it is the holder of the applicable mortgage.

Specific Performance of a Real Estate Contract Following a Sale to a Third Party: A Humpty Dumpty Story

In *Marioni v. Roxy Garments Delivery Co., Inc.* (N.J. Super. Ct. App. Div., No. A-1492-09T3, December 9, 2010), a late 2010 ruling that exhibits the breadth of the equitable powers conferred upon the courts, New Jersey's Superior Court, Appellate Division, confirmed that a contract purchaser of real property is entitled to specific performance under a purchase and sale agreement even though a third party had purchased the subject property and made substantial improvements to it.

In 1998, plaintiff Joseph Marioni entered into a contract to purchase real property in Jersey City from Roxy Garments Delivery Co., Inc. The

property remained under contract for over two years, during which time Roxy attempted to evict its tenant. The tenant was successfully evicted in October 2000 and Roxy unilaterally chose November 7, 2000, as a closing date. However, over the course of the next few weeks, the parties squabbled over the condition that the property was required to be in at the time of closing. On November 17, 2000, Roxy went so far as to return the earnest money to Marioni, claiming that Marioni breached the contract by failing to take title to the property in "as is" condition on November 7, 2000. On December 1, 2000, over a week after Marioni had returned the earnest money to Roxy, the parties agreed to credit Marioni at closing for the cost to remove debris from the property and scheduled closing for January 3, 2001. Marioni recorded a notice of settlement on December 13, 2000.

Commencing on November 17, 2000, the date that it returned the earnest money to Marioni, Roxy began to negotiate a contract with John Lindner. Evidence at trial showed that Lindner was provided with a copy of the Marioni-Roxy contract and a copy of the letter to Marioni returning the earnest money. In addition, Lindner was aware of the Marioni-Roxy contract before November 2000 because Marioni had contacted Lindner in July 2000 regarding the potential performance of restoration work at the property and Lindner had inspected the property with Marioni in October 2000. On December 8, 2000, Roxy and 94 Broadway, Inc., a corporation controlled by Lindner, entered into an agreement for the purchase and sale of the property. 94 Broadway recorded a notice of settlement on December 11, 2000.

On December 18, 2000, Roxy breached its agreement with Marioni and conveyed the property to 94 Broadway; the deed was recorded the following day. Marioni did not become aware of the conveyance until he arrived for his closing on January 3, 2001. Over the ensuing seven years, 94 Broadway made roughly \$400,000 worth of improvements to the property and subsequently leased the property to a tenant.

Marioni originally filed a complaint in the Chancery Division seeking specific performance of his contract with Roxy as well as damages. In light of Roxy's sale of the property to 94 Broadway, the Chancery Division dismissed Marioni's specific performance claim and transferred his damages claim to the Law Division. After final judgment on his damages claim was rendered, Marioni appealed to the Appellate Division to review the dismissal of his specific performance claim. The Appellate Division found that, despite Roxy's sale of the property to 94 Broadway, (i) the contract between Marioni and Roxy was still enforceable; (ii) Roxy acted wrongfully in attempting to terminate its contract with Roxy and in conveying the property to 94 Broadway; (iii) 94 Broadway was not a bona fide purchaser for value because it had actual and constructive knowledge of the Marioni-Roxy contract when it acquired the property; and (iv) because 94 Broadway had such knowledge, 94 Broadway was deemed to have acquired the property as constructive trustee for the benefit of Marioni (See *Haughwout v. Murphy*, 22 N.J. Eq. 531, 1871; *Pomeroy, Specific Performance of Contracts* § 465 (3d ed., 1926)). The Appellate Division then remanded the case to the

Chancery Division with the directive that, absent undue hardship in light of specific facts of the case, the Chancery Division "reassemble Humpty Dumpty." The transfer of Marioni's damages claim to the Law Division was vacated.

In implementing the specific performance remedy, the Chancery Division sought to equitably adjust the original Marioni-Roxy contract purchase price of \$170,000 in order to put the parties in the position they would have been in had the Marioni-Roxy contract been performed as required. Using his equitable powers, the Chancery judge increased the purchase price to \$579,135.69 based on the following calculation: (i) \$170,000 contract price; plus (ii) interest at 6% per annum over the ensuing seven years (\$85,617.13); plus (iii) the increase in market value of the property due to market conditions and renovations made by 94 Broadway (\$790,000); plus (iv) the cost of insurance premiums, property taxes and mortgage interest payments for the property that Marioni would have also been required to pay (\$71,018.56); minus (v) the cost of alterations to be made by Marioni for his intended use required as a result of 94 Broadway's renovation of the property (\$50,000); minus (vi) rents collected by 94 Broadway from its tenants (\$487,500). The Chancery judge denied Marioni's request to deduct the storage fees for his artwork that were incurred during the interim period.

On appeal, Marioni argued that the Chancery judge erred by including the increase in market value of the property in his calculation of the adjusted purchase price as well as by

excluding Marioni's storage fees as a deduction to the adjusted purchase price. In determining whether the Chancery Division judge abused his discretion or made conclusions inconsistent with his own findings of fact, the Appellate Division determined that the monetary elements of the adjusted purchase price were supported by the evidence and that, in adjusting the purchase price, the chancery judge had correctly applied the equitable principle that 94 Broadway, as a constructive trustee, could not profit as a result of its wrongful interim possession of the property. However, the Appellate Division determined that the inclusion of the increase in the property's market value due to 94 Broadway's renovations as part of the adjusted purchase price calculation constituted the award of entrepreneurial profit to 94 Broadway and therefore

constituted an error in the judge's exercise of his discretion. The Appellate Division stated that 94 Broadway was therefore entitled to reimbursement only for the cost of its renovation expenditures in the amount of \$395,883 (replacing the \$790,000 in the above calculation). The question as to whether Marioni's storage fees should be deducted from the adjusted purchase price was remanded to the Chancery Division.

The decision in *Marioni v. Roxy Garments Delivery Co., Inc.*, is instructive. It serves to remind us that the remedy of specific performance remains available to a contract purchaser even if the seller breaches the contract by selling the underlying asset to a third party. It also magnifies the importance of a notice of settlement because in order to avail itself of the specific performance

remedy, a contract purchaser must make certain that the existence of its contract is known to third parties who are potential purchasers of the property. In a similar vein, a contract purchaser must perform updated title searches prior to closing to ensure that no intervening notice of settlement between its seller and a third party has been filed, in order to avoid being put in the position of a constructive trustee. Unlike the king's men, the equitable powers of the New Jersey Chancery Division and Appellate Division sometimes allow Humpty Dumpty to be put back together again.

Please contact any member of Lowenstein Sandler's Real Estate Practice Group with questions regarding the topics discussed in this newsletter.

¹ *Ibanez*, 2011 Westlaw 38071 at *11, quoting *Moore v. Dick*, 187 Mass. 207, 211 (1905).

² G.L. c.183 §21.

³ G.L. c.244 §14. Because only a present holder of the mortgage is entitled to foreclose on the mortgaged property, the failure to identify the holder of the mortgage in the notice of sale may render the notice defective and the foreclosure sale void.

⁴ *Ibanez*, 2011 Westlaw 38071 at *14. Massachusetts follows the "title theory" of mortgages; i.e., the granting of a mortgage vests title to property in the mortgagee while the underlying debt remains unpaid.

⁵ U.S. Bank submitted a private placement memorandum (PPM) that described the mortgaged pools and summarized the provisions of the trust agreement. Although the PPM specified that each loan to be assigned would be identified in a schedule appearing as an exhibit to the trust agreement, U.S. Bank did not provide any schedule identifying the subject loan as being among the mortgages that were assigned. Wells Fargo submitted a pooling and servicing agreement ("PSA") that referenced a mortgage loan schedule, but did not contain said loan schedule and the only schedule provided by Wells Fargo did not identify the subject mortgage.

⁶ *Ibanez*, 2011 Westlaw 38071 at *13.

⁷ Article 14 of the Real Property Actions and Proceedings Law allowing power of sale was repealed on July 1, 2009, by virtue of its natural end without renewal, although it still applies to any nonjudicial foreclosure for which a notice of pendency was filed on or before July 1, 2009.

⁸ N.J.S. 46:9-9.

⁹ An assignment is effective as long as it identifies the assignee, the assignor and the property. N.J.S. 25:1-13(a).

¹⁰ Rule 4:64-1.

¹¹ Rule 4:64-2.

¹² See *Bergman on New York Mortgage Foreclosures* §16.05[1b].

¹³ In the event of an assignment during the pendency of an action, wisdom suggests the substitution of the new mortgage holder as the plaintiff in the foreclosure action. See *Bergman on New York Mortgage Foreclosures* §23.46.

¹⁴ RPAPL §1353(2).

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