

UNIVERSITY OF DAYTON
SCHOOL OF LAW

Basic Real Estate Transactions

FINAL EXAMINATION

Professor J.G. Durham
May 2, 2001
9:00 a.m. - Noon

INSTRUCTIONS

1. You have three (3) hours to complete the examination.
2. The examination consists of two questions. Question #1 counts for 40% of your grade on the examination and you should allow about 75 minutes to answer it. Question #2 counts for 60% of your grade on the examination and you should allow about 105 minutes to answer it.
3. If you are hand writing your answers please write legibly, please write only on every other line, and please write only on the front of each page.
4. The examination is open book. You may use any written or printed materials you wish to assist you in answering the questions.
5. Be sure to state any assumptions you make and the bases for your conclusions.
6. Answer all questions with general American common law or, if appropriate, federal law. You also should include different views of an issue if there is different treatment of the issue by different states.

QUESTION #1 (40% of the exam)

Mary Winder had long been looking to buy her first house. She had a clear mental picture of the perfect house, but had trouble finding a real house that matched the house she envisioned.

She found it. It was on a quiet street with a small, well-tended garden. It had large south-facing windows and it appeared to be in perfect condition. It was owned by George Evans, who placed such a high value on it that it had been for sale for over six months. Evans had listed the house with two different realtors on successive 90 day exclusive listing agreements, but still had not found a buyer for it. The second listing agreement was with Chuck Barnes of Century 22 Realty, and it provided that Evans would pay a commission of 7% of the selling price and that it expired on January 30, 2001.

Winder first toured Evans' house on January 29, 2001 in response to an ad Evans had run in the local paper advertising the house as "for sale by owner." Winder again toured the house on January 31st and started discussing with Evans what he would sell the house for. On February 1, 2001 Winder and Evans made an oral agreement for Winder to buy the house from Evans. Winder gave Evans a check for \$5,000 and Evans gave Winder a hand written receipt that stated:

February 1, 2001

Received from Mary Winder: Five Thousand Dollars (\$5,000.00) as earnest money for the purchase of the house located at 131 Windsor Court for a total purchase price of One Hundred Forty-Five Thousand Dollars (\$145,000.00).

/s/ George Evans

Winder and Evans orally agreed that Winder would have the house inspected and title checked and that if everything "checked out" that they would close the sale on April 30, 2001.

Things did not "check out." First, it turned out that Evans did not have record title to the house but, rather, Evans was the vendee on a land contract with Marsha Libby, who was the vendor. Libby did have good record title, subject to the land contract with Evans and a mortgage with Lincoln Federal Savings, with an outstanding balance of \$80,000. Second, the house also had termites, although there was no structural damage. Finally, Winder's "home inspector" found other items to note: a door latch that did not work properly, the air conditioning compressor needed to be recharged but otherwise was working fine, the water pressure was low but within acceptable range, and the roof was quite old but there were no leaks.

Winder raised all of these items with Evans who responded by yelling at her "I am not going to make the house new for you! Take it or leave it!" Before Evans had his tantrum Winder and Evans had agreed to close the transaction at Third Title on the date they originally agreed upon, April 30, 2001.

The final straw for Winder came on April 14, 2001. That evening Evans was entertaining friends and had his outdoor grille too close to the wood siding of the house. The paint on the siding ignited and Evans had to call the fire department. About \$5,000 in damage was done to the outside of the house (some siding and roofing need to be replaced and the siding needs to be repainted) and the inside of the house (primarily water damage in the attic and to the ceilings of the rooms adjacent to that side of the

house). Winder had still been thinking about going through with the purchase, but when she heard about the fire she called Evans and told him the deal was off. Evans' response was "We'll see about that."

April 30th came and went, and yesterday morning Winder received a hand delivered letter from Evans' attorney, Vince Perry. The letter states, in pertinent part:

I represent George Evans in the sale to you of his house at 131 Windsor Court. Mr. Evans went to Third Title yesterday, April 30, 2001 the day you picked to close your purchase of Mr. Evans' house from him, ready, willing, and able to close the transaction. You did not appear nor did you submit funds to Third Title necessary to close your purchase of Mr. Evans' house. I am writing to inform you that you are in breach of your contract with Mr. Evans and that he intends to fully pursue his legal remedies unless you immediately take the necessary steps to close your purchase of his house.

Please be advised that Mr. Evans had the house treated for termites and that he has arranged for good and marketable title to be conveyed to you by a special warranty deed. If you do not close your purchase of Mr. Evans' house he will incur substantial damages. If you do not arrange to close your purchase of Mr. Evans' house by Friday, May 4, 2001 I will immediately file suit against you on behalf of Mr. Evans seeking both injunctive relief and monetary damages.

I recommend that you obtain legal counsel immediately.

Sincerely,

/s/ Vince Perry

Mary Winder found her way to your office yesterday afternoon. You talked with her and reviewed the rather limited documents she showed to you: the receipt from Evans; the report by the termite inspector; the report by the "home inspector;" and a title report from Third Title. You decided to represent Winder, and you had her sign a statement that you are her attorney and that you are entitled to all information about her transaction with Evans. After she left you called Third Title to determine if, in fact, Evans had established an escrow to close the transaction. The Escrow Officer at Third Title told you that on February 8, 2001 Evans signed an escrow agreement with Third Title providing for the sale of Evans' house to Winder to be closed by Third Title on April 30, 2001. The Escrow Officer faxed the escrow agreement to you and it is quite straight forward. It states that Evans is the seller, Winder is the buyer, the purchase price is \$145,000, Third Title is to pay off both the land contract vendor Libby and her mortgagee Lincoln Federal Savings, and Chuck Barnes and Century 22 Realty are to receive a real estate sales commission of \$10,150.

It is now Wednesday morning, and you are pondering just how you will proceed. Winder has an appointment to talk with you at 11:00 a.m. Please answer the following questions to help you organize your thoughts:

- a. Do Winder and Evans have a binding contract?**
- b. If Winder and Evans do not have a binding contract, what are Winder's options if she does not want to close the transaction?**
- c. If Winder and Evans do not have a binding contract, what are Winder's options if she does want to close the transaction?**
- d. If Winder and Evans have a binding contract, can Winder cure the breach and, if so, how? If she chooses to cure the breach may she be forced to pay \$145,000 for the damaged house and does she have to take a special warranty deed?**
- e. If Winder and Evans have a binding contract and Winder does not cure the breach, what remedies might Evans have against Winder?**
- f. If Winder and Evans have a binding contract, Winder does not cure the breach and Evans chooses to sue for damages, what are Evans' damages?**

QUESTION #2 (60% of the exam)

Whitehorse, Limited specializes in locating under-performing shopping centers, acquiring them at bargain basement prices, and then improving the centers' returns on investment so that the centers can be either held for long-term investment or sold within a few years at a profit. About five years ago Whitehorse bought the 200,000 square foot County Square Center ("CSC") in the city of Eureka. Eureka is the county seat of Armstrong County and has a population of about 50,000. CSC is near the courthouse and downtown Eureka. CSC was built in 1975 and is a fairly typical small city shopping center. At the time Whitehorse acquired CSC its anchors were a chain grocery store and a chain drug store with a variety of local businesses ("Ben's Liquors"), franchise stores ("Baskin Robbins") and national chain stores ("Radio Shack") as the other tenants. Whitehorse was attracted to CSC because although it was not well maintained and had several vacancies, the existing tenants were of good quality and most of the existing leases ran for five to ten more years. Whitehorse therefore was able to buy CSC for \$4,100,000, far below its replacement value (the value of the land, if vacant, plus the cost of constructing the improvements), which Whitehorse estimated to be closer to \$10,000,000.

Whitehorse bought CSC from a local attorney named Bret Eastman who dabbled in real estate investment and development and was the original developer of CSC. Whitehorse has a standard "due diligence" procedure it uses when it acquires a shopping center. It demands a full rent roll, has a

complete title search done, has a thorough physical inspection made of the site and the improvements, and has a basic marketing analysis done. Both before it made its offer to buy CSC from Eastman, and after Whitehorse completed its due diligence, CSC appeared to be an ideal acquisition: Whitehorse's acquisitions team felt that with the maintenance items and improvements that it had priced out that CSC could be brought to near full capacity and would be a solid performer for Whitehorse. To help fund these maintenance items and improvements Whitehorse insisted that Eastman agree to take \$500,000 of the purchase price in the form of a non-recourse promissory note secured by a mortgage on CSC.

Whitehorse did encounter a few rocks on the road to closing its purchase of CSC, however. Eastman had not included "estoppel certificate" clauses or agreements to subordinate to new financing in his leases for CSC so the tenants could not be made to sign estoppel certificates or subordinate to any new financing. Whitehorse found ways to deal with these problems. First, Whitehorse's agent was able to confirm the rent roll by reviewing Eastman's books for CSC. Then, Whitehorse was able to convince its lender, the insurance company Mutual of Topeka ("Mutual"), to make a \$3,000,000 loan to fund Whitehorse's purchase of CSC even though the existing leases would not be subordinated to the new loan. Mutual did require, however, that loan be recourse and that the mortgage include an absolute assignment of rents. In addition to being secured by a first mortgage on CSC, Mutual also required that its loan be secured by a mortgage on another shopping center owned by Whitehorse, the Mission Hills Plaza shopping center ("MHP") in the nearby city of Golden. All three mortgages were properly recorded upon Whitehorse's close of the purchase of CSC, Mutual's and Eastman's mortgages on CSC (Eastman's mortgage being recorded after Mutual's) and Mutual's mortgage on MHP in Golden. Mutual's mortgages included powers of sale, which are allowed by state law, as well as an agreement that Mutual may have a receiver appointed upon default by Whitehorse.

Things did not go well after Whitehorse took possession of CSC. First, the maintenance and repairs were much more extensive than Whitehorse's acquisition team had estimated; they suspected that Eastman had covered up some problems but they did not feel that Whitehorse could prove fraud. Then just as Whitehorse was completing its maintenance and improvements, a regional shopping center developer announced that it was going to build a new center on the outskirts of Eureka. The new center was going to be anchored by a Wal-Mart and feature a discount grocery store, several national retailers, and out lots for fast food franchise restaurants, including a McDonald's. Whitehorse's marketing plan was up in smoke, and it was unable to lease any of the empty storefronts at what it consider to be "market" rents. The new Wal-Mart center opened about 18 months later (30 months after Whitehorse closed on the purchase of CSC).

It was all down hill from there. Not only was Whitehorse not able to rent any of the vacant storefronts in CSC, but several tenants either moved into the Wal-Mart center when their leases at CSC were up or went out of business because competing businesses had opened up in the Wal-Mart center. CSC had turned out to be a disaster as an investment for Whitehorse. The monthly rents from CSC's remaining tenants are far less than Whitehorse has to pay Mutual on the mortgage, not to mention what it has to pay Eastman on his mortgage. CSC clearly now is worth less than Whitehorse paid for it, and certainly less than Whitehorse's investment in it (the purchase price plus maintenance and improvements). In fact, CSC is worth far less than the principal balance on the mortgage to Mutual.

You are an associate in a law firm that represents Mutual. The partner in charge of Mutual's business with your law firm asks you to do some factual research and to write a memo to her. First you talked with Mutual's loan collection department and got the bad news. Mutual's staff has concluded that CSC is worth no more than \$2,000,000, and the balance on Mutual's loan to Whitehorse is \$2,850,000.

The good news is that MHP is thriving and that Whitehorse may have other assets Mutual can reach. The news is not all good because Mutual did not closely investigate MHP's debt structure when it accepted the mortgage on MHP. MHP, like CSC, is encumbered by two purchase money mortgages, one to an institutional lender, the Steamfitters Pension Fund ("SPF") and the other to the seller of MHP to Whitehorse. MHP likely is worth about \$5,000,000, but the principal balance on SPF's mortgage is \$3,600,000 and the principal balance on the seller's mortgage is \$600,000. SPF's note and mortgage are open ended, that is the promissory note initially was for \$3,000,000 but it allowed for future advances up to a limit of \$4,000,000 if Whitehorse could show that the value of MHP had increased sufficiently so that the principal balance did not exceed 70% of the value of MHP. All the future advances were made by SPF after Mutual recorded its mortgage on MHP. Finally, SPF's mortgage also includes a clause which states: "If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, Lender may, at Lender's option, declare all the sums secured by this mortgage to be due and payable."

In your memo to your partner please address the following questions:

a. Would you recommend that Mutual accept a deed in lieu of foreclosure of Whitehorse's interest in CSC as partial or full satisfaction of principal balance on the loan, and if so under what conditions?

b. If Mutual decides to foreclose, would you recommend that Mutual use the powers of sales in its mortgages or would you recommend that Mutual proceed by judicial foreclosure?

c. If Mutual brings a legal action for foreclosure of Whitehorse's interest in CSC, who are the necessary and proper parties to that action?

d. If Mutual brings a legal action for foreclosure of Whitehorse's interest in MHP, who are the necessary and proper parties to that action?

e. If Mutual brings a legal action for foreclosure of Whitehorse's interest in CSC, what are the advantages and disadvantages of Mutual's seeking to have a receiver appointed by the court, and do you think that a court will appoint a receiver if Mutual requests that one be appointed?

f. If Mutual brings a legal action for foreclosure of Whitehorse's interest in CSC, on what basis can Eastman assert the priority of his mortgage over Mutual's, or at least that Mutual cannot

resort to its lien on CSC first?

g. If Mutual brings a legal action for foreclosure of Whitehorse's interest in MHP, what will be the priority of the initial advance under SPF's mortgage as opposed to the future advances?

END OF THE EXAMINATION