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THE FUTURE OF CREDIT RATING AGENCIES

By Anthony La Malfa

The first credit ratings appeared in the United States in 1909, when John Moody began analyzing the stocks and bonds of America's railroads after the stock market crash of 1907. The ratings were based on letter rating symbols that were adopted from the mercantile and credit rating system that had been used by credit reporting firms since the late 1800s. Thus John Moody & Company became the first to rate public market securities. In a September 2007 speech, Christopher Cox, former chairman of the U.S. Securities & Exchange Commission (SEC), noted that beginning in 1975 the SEC began to make explicit reference to credit ratings in its rules, using credit ratings by market-recognized rating agencies to distinguish among grades of creditworthiness for various purposes under the federal securities laws. The SEC originally adopted the term "NRSRO" (Nationally Recognized Statistical Rating Organizations) in 1975 solely for determining capital charges on different grades of debt securities under the SEC's net capital rule for broker-dealers.

▶CREDIT RATING AGENCIES AND THE FINANCIAL CRISIS

The credit rating agencies have been subject to much criticism, and even some blame, for the financial crisis which started with the collapse of the subprime mortgage market. The criticism comes from the failure of the credit ratings to accurately reflect the risks embedded in the complex structured securities that had become so popular. This failure stems from a number of factors, from possibly being overly optimistic in awarding higher ratings to many offerings, to potential conflicts of interest between the rating agencies and the issuers of structured products, which the U.S. government sought to address, first in the Credit Rating Agency Reform Act of 2006, and subsequently in the

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NEW MONEY LAUNDERING RULES

By Brian Bader

Proposed regulations have been issued by the U.S. Treasury Department's Financial Crimes Enforcement Network (FINCEN) that would require the establishment of anti-money laundering and compliance programs with the Bank Secrecy Act (BSA) by nonbank home mortgage lenders and originators.

The proposed regulations extend the anti-money laundering and suspicious activity requirements that have long been imposed on financial institutions to nonbank residential mortgage lenders and originators, now not covered by the rules. These requirements include, but are not limited to, the development of internal policies and controls, training, and the designation of a compliance officer. The proposed rules would not apply to banks, persons regulated by the SEC or Commodities Futures Trading Commission or any person employed by a financial institution.

The proposed regulations define a residential mortgage lender as an individual to whom the debt arising out of the residential mortgage is initially payable or to whom the debt is assigned to after settlement. Individuals financing the sale of their own property would not be considered a mortgage lender. A residential mortgage originator is an individual who negotiates the terms of mortgage for compensation. Mortgage loans are considered residential mortgage loans if they are secured by a one-to-four unit residential structure or real estate on which the construction is intended.

As concerns over the financing of terrorist activities and money laundering heighten, mortgage lenders and originators are going to be required to develop anti-money laundering programs within six months after the effective date of the final regulations or six months after a lender or originator becomes subject to the new rules. Compliance officers within the company would be responsible to oversee that such a program is implemented, employees are properly trained and the program is current. If the mortgage lenders and/or originators suspect that a transaction involves illegal activity or intends to evade BSA requirements, they would be responsible for filing a suspicious activity report with FINCEN. The reports are required for the most part to be filed within 30 calendar days after the company detects the suspicious activity.

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TAX-DEFERRED EXCHANGES: PITFALLS TO AVOID

By Robert Klein

One of the few tax breaks available to real estate investors and businesses is the nonrecognition provision in Section 1031 of the tax code. Generally, this section provides that gain is not recognized when property held for investment or for productive use in a trade or business is exchanged for "like-kind" property (the replacement property). If cash or property that is not like-kind ("boot") is received in addition to the replacement property, the amount of the gain is limited to the fair market value of the boot. However, investors must be careful to avoid the many pitfalls that exist if an exchange is not structured properly. Some of these are described below.

▶REPLACEMENT DEBT

While investors understand the net proceeds received from a sale of their relinquished property must be invested in like-kind replacement property, many fail to realize they must also replace any discharged debt. For example, if an investor exchanges a property for $100,000, subject to debt of $75,000, the investor must not only reinvest the $25,000 of equity but also the debt of $75,000. The investor can take on more debt to acquire a higher-valued property as long as all of the net equity is reinvested. If the investor invests only the net equity, the IRS will impose a tax on the "debt release" experienced in the exchange.

▶FAILURE TO IDENTIFY PROPERTY

Identifying a property for exchange may be done improperly. Most exchange companies (known as Qualified Intermediaries) provide a sample form for use in identifying potential replacement properties. Some of the common errors made in completing an identification statement include failing to have a spouse sign the statement; entering the wrong street address or lot number; or failing to note the purchase is for only a percentage of the exchange property.

▶LIMITING EXCHANGES TO ONE PERSON

Initially, all exchanges were two-party exchanges. In 1979, following a court ruling, the IRS changed the regulations to utilize Qualified Intermediaries. This permitted the property owner, through the intermediary, to offer the property to any interested buyer.

▶DIFFERENT PROPERTY TYPES

For the purposes of 1031 exchanges, all real property is considered like-kind with all other real property as long as the properties are held either for investment or business use. Thus rental properties are like-kind to commercial buildings and improved properties are like-kind to raw land. Fractional interests (held as

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TAX-DEFERRED EXCHANGES: PITFALLS TO AVOID

tenants in common) are like-kind to owning a fee simple interest. Long-term ground leases with 30 years or more remaining on the lease can be like-kind to other real property interest.

▶INVESTMENT OR BUSINESS USE

An important rule to be observed is that the properties in the exchange must be held either for investment or business use, but not for both. With proper planning, however, this limitation can be overcome. For example, holding a condo for investment purposes for at least two years and then converting it to personal use is permitted. Another rule to observe is to avoid an immediate sale of the received property because the IRS takes the view that in such a case, the property was held primarily for sale rather than for investment.

▶CONSULT WITH ADVISOR(S)

It is always a wise step to consult a tax or legal advisor to be sure the transaction you are considering makes sense. For example, an investor who has incurred losses from other business transactions has no need for an exchange. Other such issues can be resolved with the expertise of an experienced Qualified Intermediary.

▶MISSING A DEADLINE

The strict time deadlines often associated with a 1031 exchange is the most difficult aspect of these exchanges. An investor has 45 days from the date the relinquished property closes to identify a replacement property and 100 days (or the tax filing deadline, whichever comes sooner) in which to close on the identified property. The time deadlines are not extended for weekends or holidays.

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PURCHASE AND SALE: LETTER OF INTENT

By David Tevlin

In a highly uncertain real estate market, buyers and sellers should consider the advantages of a preliminary written agreement known as a letter of intent (LOI). The LOI has two purposes: (1) to identify all relevant economic and business terms of the proposed transaction; and (2) provide a basic outline of the anticipated transaction.

The most important issue to be addressed at the outset is whether the parties intend the LOI to be legally binding or legally nonbinding, and/or binding in certain respects but not in others. It is not enough for the parties themselves to be clear about the nature of the LOI; the language in the LOI must also clearly indicate the intent of the parties since, in the event of litigation, a court will look to the language of the document to determine the parties' intention.

▶PURPOSES OF AN LOI

If the LOI is not intended to be binding in any way, why enter into one? Three reasons are as follows: (1) to determine if each party is seriously interested in consummating a transaction, thus minimizing legal and other expenses in fruitless negotiations; (2) if the transaction is to be financed by an issue of securities, the underwriting firm may require an LOI as a "comfort document" to justify the time and expense of a "due diligence" investigation; and (3) in a negotiation

that may take many months, an LOI may prevent misunderstandings by identifying the intentions of the parties at the inception of the negotiations.

In order to encourage serious negotiations, an LOI may emphasize the parties' obligation to negotiate in good faith, even when the LOI is not legally binding. A 1999 decision by a Delaware Court awarded $30 million in damages to a disappointed buyer after the seller sold to another buyer despite continuing negotiations pursuant to an LOI.

▶SCOPE OF LOI

An LOI that is intended to be nonbinding often is prepared by a principal of one of the parties or by a real estate broker without consulting legal counsel. This may not be a good idea, since, as already noted, a court interpreting the LOI will look to the language of the document rather than the oral testimony of the parties as to their true intent. An LOI should contain most or all of the contingencies and conditions intended to be in the final contract. Such contingencies include inspections of the property, review of leases and other relevant documents, environmental audits, feasibility studies, and approval by the board of directors or governing body of a party.

▶WARRANTIES AND REPRESENTATIONS

At the very least, an LOI should specify that each party's obligations in the final agreement will be conditioned upon receiving the

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usual and customary representations and warranties, such as no pending litigation, and no notice of condemnation or other governmental action that would frustrate the purpose of the transaction.

CONFIDENTIALITY

One or both parties may wish the LOI to remain confidential, even though a final agreement will not be. A seller may not wish to have it known that a property is available for sale, while the buyer may not wish to stimulate any competitive interest.

EXCLUSIVITY

A buyer may wish an LOI to state that the buyer has an exclusive right to negotiate for a specified period, during which time the seller will not negotiate with other parties. Such a provision is an express statement of an implied obligation to negotiate in good faith, as stated above.

EXPIRATION DATE

Whether an LOI is binding or not, a prudent practice is to set a deadline for an agreement to be reached. If the parties are still negotiating at that time, an extension can easily be agreed to, whereas each party may wish to be in a position to terminate the negotiations.

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THE FUTURE OF CREDIT RATING AGENCIES

Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act).

CREDIT RATING AGENCIES UNDER THE DODD-FRANK ACT

The Dodd-Frank Act contains a series of rules for NRSROs designed to address internal controls, transparency, and other factors contributing to the ratings failures. The Dodd-Frank Act creates a new office at the SEC's Office of Credit Ratings, with its own compliance staff and the authority to fine agencies. The SEC is required to examine NRSROs at least once a year and make key findings public. The Dodd-Frank Act also contains a number of other requirements discussed below.

GOVERNANCE AND COMPLIANCE RULES

The Dodd-Frank Act requires each NRSRO to have a board of directors in which at least half are independent members, some of whom must be users of NRSRO ratings. In addition, the Act requires the board to oversee policies for conflicts of interest; procedures for determining ratings; and the effectiveness of internal controls regarding procedures and policies for compensation and promotion.

A compliance officer in a NRSRO cannot perform credit ratings or marketing or sales functions, participate in developing ratings or engage in setting compensation levels. The compliance officer must establish procedures for treatment of complaints regarding credit ratings and compliance with securities laws as well as complaints by employees or users of ratings. The Act requires each NRSRO to submit an annual report to the compliance officer addressing compliance with policies and procedures.

PENALTIES AND LIABILITY

The Act establishes penalties that the SEC can impose on persons associated with an NRSRO. The Act includes as a misconduct the failure to reasonably supervise an individual who commits a violation of the securities laws. The Act allows the SEC to suspend or revoke the registration of an NRSRO with respect to a particular class of securities upon determining, after a hearing, that the NRSRO lacks sufficient financial or managerial resources to consistently produce ratings with integrity. This means the SEC must consider whether an NRSRO failed to produce accurate ratings over a sustained period, which places the SEC in the position of assessing the quality of ratings and the means necessary to produce accurate ratings.

Each NRSRO must refer to law enforcement or regulatory authorities any credible information received by a third party that alleges an issuer of securities rated by NRSRO committed a material violation of law.

RIGHT OF ACTION

The Act establishes that the enforcement and penalty provisions of the Act apply to statements made by credit rating agencies in the same manner and to the same extent as they apply to statements made by registered public accounting firms or securities analysts under the securities laws.

STATE OF MIND

The Act modifies the requisite "state of mind" requirements for a private securities fraud action seeking money damages from a credit rating agency or controlling person. It is sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the rated security. Factual elements of the rated security are based upon its own methodology for evaluating credit risk or failure to obtain reasonable verification of such facts.

INTENDED CONSEQUENCES

Some critics and commentators have asserted that the use of credit ratings permitted under U.S. laws and regulations contributed to an over-reliance on credit ratings and to incorrect assumptions that such credit ratings had an implicit government seal of approval. The obvious goal of this latest round of rulemaking is to establish a more reliable, transparent, and sound rating system through oversight. The assumptions that credit ratings have an implicit government seal of approval will no longer be incorrect.

A summary of the Dodd-Frank Act can be accessed at: http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

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MORTGAGES: FAILURE TO HONOR PROMISE TO NEGOTIATE VIEWED AS POTENTIAL FRAUD

By Alvin Arnold

A common allegation heard from defaulted homeowners and their attorneys is that lenders are promising to negotiate modifications, then foreclosing without following through on the promised negotiations. In a recent decision, a California Appellate Court has held that such allegations may provide a basis for a claim of fraud or promissory estoppel. *Aceves v. U.S. Bank, N.A.*, 2011 WL 242426 (Cal. Ct. App. 2d Dist. 2011)

DEFAULT AND BANKRUPTCY

The following facts are those alleged in the *Aceves* complaint (taken as true for the purpose of determining whether the trial court was correct in dismissing the case on the pleadings). Claudia Aceves took out a mortgage loan for $845,000 in 2006, with initial monthly payments of $4,857. She defaulted on that loan, and on March 26, 2008, she was served with a notice of default and intent to foreclose nonjudicially. She then filed for Chapter 7 bankruptcy, and as a result, the lender's enforcement actions were stopped by the automatic stay.

Aceves then contacted the lender and was told that once her loan was out of bankruptcy, the bank "would work with her on a mortgage reinstatement and loan modification." The bank asked her to submit documents for its consideration, which she did. Meanwhile, the bank filed a motion to lift the automatic stay and proceed with its foreclosure. In reliance on the lender's promise to work with her on a loan modification, Aceves did not oppose the motion to lift the stay, and decided not to convert her Chapter 7 case to a Chapter 13 (under which she could have tried to reinstate the mortgage). As a result, the bankruptcy court lifted the automatic stay and the bank scheduled the foreclosure sale.

Aceves attempted to negotiate a loan modification, but was told that no modification was possible because the "file" had been "discharged" in bankruptcy. The lender contacted her shortly thereafter, stating that it had mistakenly believed the loan was discharged, and the bank would in fact consider a loss mitigation proposal. The day before the foreclosure sale, the lender contacted her bankruptcy attorney and offered to reinstate the loan with a current balance of $965,926 and a new payment of more than $7,200 per month. The lender refused to put this offer in writing, and Aceves rejected the offer. The next day, the home was sold in foreclosure.

PROMISSORY ESTOPPEL AND FRAUD

According to the complaint, the lender never intended to work with Aceves to modify the loan, and only promised to negotiate so she would forgo the bankruptcy proceedings, enabling them to foreclose. The trial court dismissed the complaint. On appeal, the court reinstated Aceves's complaint with respect to two causes of action: promissory estoppel and fraud. Promissory estoppel requires a clear and unambiguous promise, on which the other party reasonably relies, and injury caused by that reliance. The court held that the promise to work with her on a mortgage reinstatement and loan modification if she dropped her bankruptcy case was clear and unambiguous. She reasonably and foreseeably relied on the promise by not opposing the motion to lift stay, and by not seeking a Chapter 13 bankruptcy plan.

The lender argued it was not bound by its gratuitous oral promise to postpone the sale and negotiate, under a California statute that provides a written contract can only be modified in writing or by an executed oral agreement. However, the court noted that the statute did not preclude a claim for promissory or equitable estoppel, where detrimental reliance serves as a substitute for the consideration ordinarily required to create an enforceable promise.

Having reinstated the claim for promissory estoppel, the court allowed a course of action for fraud. The elements of fraud are basically the same as promissory estoppel, with the additional requirement that the promissory had to know of the falsity of its promise when it made that promise. Here, those facts were alleged. Notwithstanding its determination that the plaintiff had viable claims for relief, the court held that the foreclosure sale itself could not be invalidated because there were no significant irregularities in the foreclosure sale, nor had she paid the funds needed to reinstate the loan before foreclosure. The plaintiff would be limited to monetary damages if she proved her claims. One defense offered by the lender was that it had honored its promise by the offer of reinstatement it made the day before the sale. The court rejected this defense, finding that a unilateral offer would not satisfy the alleged promise to negotiate in an attempt to reach a mutually agreeable loan modification.

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