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Fannie Mae and Freddie Mac: What Will Be Their Future Role in Multifamily Housing Finance?

By Kenneth G. Lore and Harold A. Levy

Fannie Mae and Freddie Mac (often referred to as government-sponsored enterprises or "GSEs") have played a critical role in multifamily housing finance. Both GSEs are currently under conservatorship as a result of the 2008 financial crisis, and both Congress and the Administration are intent on GSE reform. This article reviews the role of the GSEs in multifamily housing finance, their current status, and the options that are being considered to replace or restructure the GSEs.

TRADITIONAL ROLE OF THE GSES

The GSEs are federally chartered corporations that purchase mortgages and either hold them in portfolio (in the case of certain multifamily mortgages) or securitize them and sell the securities to investors. The GSEs have traditionally benefitted from an implicit government guaranty. They are regulated by the Federal Housing Finance Agency (FHFA), which was created by the Housing and Economic Recovery Act of 2008 (HERA). In the years immediately preceding the 2008 financial crisis, the GSEs generally financed approximately 27–29 percent of multifamily mortgages. Beginning in 2008, while the overall volume of multifamily lending decreased sharply, the GSEs' market share of originations escalated dramatically to a peak of 85–90 percent in 2009, and has now returned to about 45 percent.

The GSEs' multifamily business has had default rates substantially below their single family portfolios. For example, at the end of 2011 Fannie Mae's and Freddie Mac's serious delinquency rates for single-family loans were 3.91 percent and 3.59 percent respectively, while their serious delinquency rates for multifamily loans were only 0.59 percent and 0.22 percent respectively. The GSEs' multifamily portfolio is also substantially healthier than the private multifamily portfolio; for example, for the second quarter of 2013, Fannie Mae and Freddie Mac had multifamily delinquency rates of 0.28 percent and 0.09 percent respectively, while banks and thrifts and commercial mortgage-backed securities had multifamily delinquency rates of 2.16 percent and 7.81 percent respectively.

AFTERMATH OF THE FINANCIAL CRISIS

The FHFA placed the GSEs into conservatorship on Sept. 6, 2008. The GSEs' operations have been stabilized and currently operate profitably; Fannie Mae and Freddie Mac reported net

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Pro-Developer Decision by the U.S. Supreme Court May Have Unintended Consequences

By Camarin E.B. Madigan

Property owners nationwide may be encouraged by the Supreme Court's recent ruling in *Koontz v. St. Johns River Management District* (133 S. Ct. 2586) that denial of a development permit could be considered a taking of property. But while the decision seemingly expands the definition of the Takings Clause, this case, which has been in litigation for the past 19 years, may have unintended consequences. In limiting the range of development pre-conditions exacted from developers, it may, as a practical matter, also delay the timing and increase the costs of the permitting process across the country.

PERMIT APPLICATION DENIED DUE TO FAILURE TO SATISFY DISTRICT'S CONDITIONS

In 1972, Coy Koontz, now deceased, purchased 14.9 acres of property east of Orlando, Fla. The property, which contains wetlands, is now adjacent to a major highway in a highly developed area. At the time of the acquisition, no environmental laws existed that would have prevented Koontz from developing this property. However, in the 1990s, when Koontz wanted to develop a portion of his property, most of his property was within a designated riparian habitat protection zone.

In 1994, Koontz applied to the local water management district for a permit to develop a building, parking lot and retention pond on 3.7 acres of his property and to dredge 3.25 acres of wetlands. Koontz offered to grant a conservation easement to the state over the remaining 11 acres of his property as mitigation. The district, however, denied the permit and informed Koontz that it would approve the application only if he agreed to one of the following concessions:

- Reduce the development's footprint to one acre; or
- Pay the district to enhance approximately 50 acres of district-owned wetlands, which were located several miles away from Koontz's property.

Believing the district's demands for mitigation to be excessive, Koontz filed an inverse condemnation action in state court alleging that the district's denial constituted a taking without just compensation. After a trip to the Court of Appeal, Koontz was awarded $376,154 in damages by the trial court, which determined that demanding anything more than a conservation easement over the remaining 11 acres failed to meet the "nexus" and "rough proportionality" tests of *Nollan v. California* (1987) and *Dolan v. City of Tigard* (1994). In 2011, the Florida Supreme Court reversed, holding that Nollan and Dolan were not applicable because the district denied the application rather than approving it with conditions and because the district had demanded only money (in the form of offsite mitigation) rather than an interest in real property.

U.S. SUPREME COURT REVERSAL—DENIAL OF THE PERMIT WAS A TAKING

In June of this year, the U.S. Supreme Court ruled in a 5-4 decision written by Justice Alito that when any governmental entity engages in land-use regulation, whether by denying a permit or demanding payment as a condition for a permit, that entity must show that there is a nexus and rough proportionality between its conditions and the impacts of the proposed land use. The nexus and rough proportionality tests are a special application of the unconstitutional conditions doctrine.

DEVELOPERS ARE PROTECTED FROM GOVERNMENTAL COERCION

The government is prevented from conferring a benefit on the condition that the person benefited surrenders a constitutional right, even though the government may otherwise rightfully withhold the benefit. In the land-use context the unconstitutional conditions doctrine is particularly important where "applicants are especially vulnerable to … [governmental] coercion … because the government often has broad discretion to deny a permit that is worth far more than property it would take … [and] can pressure an owner into voluntarily giving up property for which the Fifth Amendment would otherwise require just compensation." This is true even when the denial did not result in any property actually being taken. "Extortionate demands for property in the land-use permitting context run afoul of the Takings Clause not because they take property but because they impermissibly burden the right not to have property taken without just compensation." Therefore, the impermissible denial of a permit is a constitutionally cognizable injury.

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Hotel Management Agreements After *Marriott v. Eden Roc*: Will It Trigger a Wave of Terminations?

By Ferdinand J. Gallo III

The relationship between a hotel owner and hotel operator is complex. While the owner bears the financial risk of the gain or loss in value of its asset, the operator has an almost unfettered right to manage the owner's business and is paid a fee for its management services whether the hotel is profitable or not. While a hotel management agreement with an established hotel "brand" operator offers an owner a number of benefits, including reputable "brand standards" recognized by hotel guests, a standardized and far-flung reservation system, international marketing and advertising and well-trained staff, there are certain trade-offs. For instance, hotel operators may incur what an owner may consider unwarranted expenses in strict adherence to "brand standards," may be slow to respond to changes in market circumstances and may not put an owner's interest in preserving its asset and maximizing profit above its own goals in the operation of the property.

The ability to terminate a hotel management agreement is of critical importance to hotel investors, providing them with the flexibility to protect assets or to realign the operations of the hotel asset in order to maximize the return on investment.

Historically, efforts by owners to terminate long-term hotel management agreements, even in light of express prohibitions to the contrary contained in such agreements, were limited to exercising such termination rights under common law agency principles. However, under a recent decision by the New York Appellate Division, hotel owners may avail themselves of an additional rationale bolstering the right to termination — the characterization of a hotel management agreement as a personal services contract.

AGENCY PRINCIPLES

Hotel management agreements (and most real estate management contracts) are agency contracts. A hotel manager is granted broad authority in operating a hotel asset, including the power to bind an owner to contractual obligations, purchase goods and services for the property, determine renovation and other capital improvement programs, set guest room rates, and manage the cash flow of the property.

Since hotel management agreements are agency contracts, they are revocable at will by the hotel owner. Under the common law, it is against public policy for a principal to have an agent forced upon it against its will. However, where a principal terminates an agency contract prior to the end of the stated term in violation of the underlying agreement, the principal may be liable for damages as a result of the breach of the contract.

In the context of hotel management agreements, however, there is an exception to such termination rights — when an agency contract is coupled with an interest, the agency relationship is irrevocable and the agent may be able to enjoin the termination of the agency contract. For an agency to be coupled with an interest, the agent must have a "specific, present property interest" in the subject matter of the agency. Relying on the agency with an interest exception, hotel management companies have routinely sought to enjoin the premature termination of their hotel management contracts by arguing that they have an interest in the hotel.

Courts are reluctant to find the existence of an agency coupled with an interest in the context of terminations of hotel management agreements, even where the agreement expressly provides that the agency is coupled with an interest. Hotel management companies have made determined efforts to avoid this principle. First, they argued that their management agreements were agencies "coupled with an interest," and therefore irrevocable even though the operators had no present ownership stake in the hotels they managed. To preserve this fiction, the operators went so far as to include language in the contracts by which the parties agreed that the agency was "coupled with an interest." But courts around the country rejected reliance upon those clauses, looking beyond the text employed, examining the true relationship between the parties, and finding only routine revocable agency contracts. Courts have held that the mere existence of a management fee (even a so-called incentive management fee) is not sufficient an interest to make the agency irrevocable. Further, the use of a hotel operator's "brand," trademarks and service marks are not sufficient interests but merely incidental to the agency relationship.

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Resolving Real Estate Disputes: Litigation or Arbitration?

By Charles L. Solomont and Emily M. M. Carroll

Parties negotiating commercial agreements often do not address dispute resolution, if at all, until the end of the process and even then often do not focus intensely on it. Anxious to finalize a deal, contracting parties understandably concentrate on economic terms and building a positive relationship with one another rather than on how they will resolve disputes that they hope will never occur. Nonetheless, considering how to resolve future conflicts and negotiating clear dispute resolution provisions can save headaches, time and money when disagreements occur.

Disputes in the commercial real estate context take many forms: disagreements between real estate investors over partnership agreement terms; lenders seeking to enforce remedies following an event of default; landlords and tenants fighting over the terms of a commercial lease; and buyers suing over breached representations in a purchase and sale agreement, are but a few examples.

While both judges and arbitrators can adjudicate most contract disputes, only courts can implement certain remedies, such as granting lenders the right to foreclosure. Courts provide litigants access to a neutral forum with impartial judges. Requiring parties to adhere to codified, well-established procedural and evidentiary rules instills confidence in the fairness of the judicial process. The obligation of judges to decide issues based upon established case law allows parties to assume that litigation will lead to a legally correct result. The right to appeal reinforces this.

While courts offer these advantages, litigation takes a long time to complete, the discovery process can drag on, costing parties time and money, and, absent special arrangements that some courts will not approve, confidential information becomes public. In addition, the judge may not have, and a jury certainly will not have, expertise in the subject matter of the case. The right to appeal can result in further delays, increased costs and lack of finality.

In order to evade downsides of the judicial system, parties often include mandatory arbitration provisions in commercial real estate contracts. Potential litigants generally perceive arbitration as a more streamlined and thus quicker and less expensive way to resolve disputes. In theory, the process can be less formal. The standard rules of arbitration organizations such as the American Arbitration Association and JAMS provide for much more limited discovery than judicial rules of evidence. Commonly cited advantages of arbitration include its more flexible and less formal rules of evidence, confidentiality (since, among other things, it creates no public record), and the freedom of parties to select arbitrators with expertise in the subject matter. Complex or more heavily negotiated arbitration provisions, however, can diminish some of these advantages by, for example, specifically entitling the parties to extensive discovery and/or requiring the arbitrator to apply the rules of evidence strictly. One growing criticism of commercial arbitration is that it is becoming more time-consuming and less cost-effective as parties increasingly include provisions for broad discovery and courtroom-like procedures, which can be cumbersome and time-consuming. Further, most federal and state arbitration statutes make the grounds upon which courts can overturn an arbitration decision so narrow as to render such decisions essentially non-appealable. This provides certainty and finality as to the result but can leave parties without recourse if they believe the arbitrators made serious mistakes or reached the wrong result.

Given the advantages and disadvantages of both arbitration and litigation, clients and lawyers should always consider whether to include mandatory arbitration clauses in their real estate agreements. Once a dispute arises, agreements become more difficult to make. Consequently, absent an arbitration clause, parties rarely agree to arbitration after a dispute arises. The more the dispute parallels a collection action, the more the party initiating the action will want to preserve judicial remedies (i.e., foreclosure and other collection remedies). Lenders also tend to prefer the judicial process because they can resort to an appeal if case law is not applied properly. Outside the lending context, parties more frequently will consider mandatory arbitration for its streamlined nature, confidentiality and finality.

Arbitration clauses take many forms ranging from a few short sentences to much more elaborate provisions with detailed procedures. Basic provisions may simply state that the parties agree to settle any dispute arising under the contract through arbitration administered by the American Arbitration Association (the "AAA") or JAMS (which is an acronym for its former name the Judicial Arbitration and Mediation Services, Inc.) and the number of arbitrators. More elaborate arbitration clauses include additional details such as (i) the qualifications each arbitrator must have (e.g., at least 10 years of experience in a particular area of expertise); (ii) the rules that will apply

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Landlord Victorious in Rare Federal Court Case Involving New York's Rent Law

By Peter C. Neger

Sometimes, there's a clear path through the "impenetrable thicket" of New York City's rent laws. At least that was the result of a recent ruling by the United States Court of Appeals for the Second Circuit, which predicted how the New York Court of Appeals would rule on an issue involving "the interplay between several local and federal housing rules and statutes that are complicated when taken alone, and positively labyrinthine when taken together." Interpreting New York's Mitchell-Lama rules, its J-51 tax abatement regulations and the complexities of the Rent Stabilization Law (RSL), the Second Circuit upheld a ruling by District Court Judge Shira Scheindlin and determined that, despite its receipt of J-51 benefits, Glenn Gardens (a Manhattan apartment building) did not become subject any other form of rent regulation upon its withdrawal from New York's Mitchell-Lama program and, therefore, did not overcharge the Government's Section 8 program for rent subsidies based on the unregulated rents charged to the building's tenants.

THE GLENN GARDENS STORY

Our client's building, Glenn Gardens, was built in the mid-1970s under New York's Mitchell-Lama law,[1] which provides tax and other incentives to developers to build low- and middle-income housing. Developers agree to restrictions on profits and on the rents that they can charge to tenants, among other things. While in the Mitchell-Lama program, Glenn Gardens received an additional tax benefit for certain capital improvements made to the property under New York City's ("the City") so-called J-51 program.[2] To be eligible to receive J-51 benefits, an owner must be or become subject to rent regulation under one of several enumerated schemes, including the RSL and the Mitchell-Lama law. Since Glenn Gardens' rents were regulated under Mitchell-Lama, it could receive J-51 benefits.

In 2003, Glenn Gardens' owners exercised their statutory right to withdraw from the Mitchell-Lama program and to raise their rents to market rates. Upon exiting the program, Glenn Gardens notified the City's taxing authorities that it was relinquishing all tax benefits. The City neglected to terminate Glenn Gardens' J-51 abatement. When Glenn Gardens learned of this oversight several years later, it notified the City and the City terminated the benefits, retroactive to the date Glenn Gardens exited Mitchell-Lama. Glenn Gardens promptly reimbursed the City for the small amount of J-51 tax benefits it erroneously received.

When Glenn Gardens withdrew from Mitchell-Lama and raised its rents, certain of its tenants qualified for federal rent subsidies under Section 8 of the National Housing Act. Under that program, the federal government paid Glenn Gardens the difference between the tenants' share of the rent (based on the tenants' respective incomes) and the actual rent charged.

TWO LAWSUITS GET FILED AGAINST GLENN GARDENS

This set of facts spawned two separate lawsuits against Glenn Gardens in Manhattan federal court. Both cases were assigned to District Court Judge Scheindlin.

A. The False Claims Act Case

In 2006, Edmund Rosner, a tenant in another former Mitchell-Lama property that had also received J-51 benefits, filed two lawsuits under seal. The cases were filed as so-called "whistle-blower" actions under the federal False Claims Act, which authorizes private citizens—denominated *qui tam* relators—to sue in federal court on behalf of the United States ("the Government") to recover from persons who make false or fraudulent claims for payment to the Government. Rosner alleged that both Glenn Gardens and the property in which he resided, Independence Plaza North (IPN), had defrauded the Government by seeking Section 8 subsidies based on the difference between the tenants' payment share and the market rents being charged by Glenn Gardens and IPN. Rosner asserted that because the buildings had received J-51 benefits when they were in Mitchell-Lama, they became subject to rent stabilization upon their withdrawal from the program. According to Rosner's suit, the Government was entitled to reimbursement for the difference between the subsidy actually paid and the subsidy that allegedly should have been paid using the lower, regulated rents. Under the False Claims Act, the Government is entitled to treble damages, and the whistleblower himself is entitled to share in the Government's award.

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1 N.Y. Private Housing Finance Law, Article II.

2 N.Y.C. Admin. Code § 11-243.

Title Insurer Defense Obligations — What Are the Limits?

By Marc Anthony Angelone

Where multiple claims are made against an insured party, should a title insurance company be required to defend all claims in the suit or only those related to title issues that are expressly covered by the title insurance policy? The answer to this question varies from state to state. In two recent Massachusetts decisions, the Supreme Judicial Court rejected the so-called "in for one, in for all" theory of trial defense obligations for title insurance companies. This article discusses the split among jurisdictions and reviews the arguments used by courts both in support of and in rejection of the "in for one, in for all" theory of trial defense. The important lesson is that insured lenders and owners need to understand the applicable law before making arrangements for the defense of multiple claims.

"IN FOR ONE, IN FOR ALL"

The "in for one, in for all" theory of trial defense obligations is typically applied to insurance companies in the case of commercial general liability insurance claims. This is a "complete defense" theory that courts employ to cause an insurance company to defend all claims that may be brought in a single litigation proceeding, even if only one of the claims brought in that action is expressly covered by the underlying policy. Therefore, if the insurance company has an obligation under this type of policy to defend one of the claims (if it is "in for one"), then the courts impose an obligation on the insurance company to defend all of the other claims brought in that suit (it is also "in for all") even if those additional claims are not covered by the policy.

The arguments used to justify this "in for one, in for all" theory are based in public policy. As articulated by a district court in Ohio, (i) it is not feasible for two different lawyers to represent an insured in one lawsuit and (ii) it would be time consuming, impractical and possibly futile to divide covered and non-covered claims. Other courts have stated that there is no reasonable means of prorating costs of defense between covered and non-covered claims. For those jurisdictions that make no distinction between general liability insurance claims and title insurance claims, such as Ohio and Illinois, courts cite these justifications as reasons for imposing the "in for one, in for all" theory of trial defense upon title insurance companies.

Other jurisdictions, such as Florida, New Jersey, South Carolina and, most recently, Massachusetts, do not impose the "in for one, in for all" theory on title insurance companies. In *GMAC Mortgage, LLC v. First American Title Insurance Co.* the Massachusetts Supreme Judicial Court refused to apply the "in for one, in for all" principle to claims under title policies. It outlined the many ways in which commercial general liability insurance and title insurance differ in order to support its ruling. The court pointed out that title insurance is "fundamentally different" from general liability insurance. Unlike other forms of insurance, title insurance is not directed at future risks. It is directed at risks that are already in existence as of the date the policy is issued. The court also noted that "a title insurance policy is not an agreement to guarantee or a warranty of the state of the title. It is, rather, an agreement to indemnify the policyholder against loss through defects in title." The court addressed the public policy concerns that led to a different result in other jurisdictions by pointing out that parsing multiple claims is not difficult for title insurance claims because, unlike general liability claims, title issues are discrete and can easily be separated from related claims.

Another distinction drawn between general liability and title insurance by this and other courts is that, unlike liability insurance policies that require ongoing premium payments, title insurance companies charge a one-time premium at the date of issuance. The logic is that title insurance companies know the limited universe of all existing title issues as of the date of issuance and, therefore, charge a one-time and relatively cheaper premium because of the more limited risks assumed. At the time the policy is issued, the title insurer searches applicable records and if there are any title defects discovered, it takes exception for those issues in its coverage and provides the insured an opportunity to negotiate and cure any such title defects before the real estate transaction is closed. As noted by the Massachusetts Supreme Judicial Court, the application of the "in for one, in for all" standard would "sweep in a whole host of uncontemplated risks into the ambit of title insurance." Therefore, a title insurer only has a duty to defend when the policy specifically envisions the type of loss alleged.

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New York Court Permits Enforcement of Bad Boy Guaranty During Foreclosure Proceeding Despite 'One Form of Action' Rule

By Ferdinand J. Gallo III and Henry S. Healy

On the eve of a foreclosure auction, the borrower files bankruptcy proceedings. This is the most frustrating development a lender may encounter in the course of a real estate workout. Due to the automatic stay imposed by the bankruptcy code, a bankruptcy filing brings the foreclosure proceeding to a halt. This is a particular problem for non-recourse lenders, where foreclosure on the collateral is usually the only way to get paid in the event of a loan default.

In order to deal with this problem, non-recourse lenders have developed exceptions to non-recourse carveouts or so-called "bad boy" guarantees. These are guarantees that, among other things, make the guarantor liable for the full amount of the loan if the borrower initiates a bankruptcy proceeding or otherwise opposes the exercise of lender's default remedies. In New York, however, lenders have been concerned about a practical problem in the enforcement of these guarantees. Foreclosures on properties located in New York State are normally conducted through judicial proceedings. New York has a "one form of action" rule applicable to these proceedings. This rule provides that while foreclosure proceedings are pending, no other action may be commenced to recover any part of the mortgage debt without permission of the court.[1] Except for actions to collect a deficiency after foreclosure is completed, this means that once foreclosure proceedings are commenced, the lender may be unable to sue the guarantor to enforce a bad boy guaranty.

A recent decision of the Supreme Court for New York County points the way toward resolution of this problem.[2] In that action, the original lender made a $29 million non-recourse loan to a borrower secured by a mortgage on a Manhattan building located at 172 Madison Avenue. The borrower's principal/owner signed a bad boy guaranty. A bankruptcy filing by the borrower was one of the events triggering the guarantor's liability for the full amount of the debt under the guaranty. The borrower defaulted under its mortgage loan, and foreclosure proceedings were commenced by the original lender's successor, as holder of the mortgage note. The court granted the lender's motion for summary judgment, and an order was entered directing the sale of the property at public auction. The auction was scheduled for July 10, 2013. On the day scheduled for the auction, the borrower filed for bankruptcy.

The lender then moved for summary judgment against the guarantor. The guarantor objected in reliance on the "one form of action" rule. The court noted that, generally speaking, the election to foreclose a mortgage bars an action on the debt, absent leave of court. It then pointed out that under established New York law, the election of remedies doctrine only operates where there was a choice of remedies available *at the time the original judicial proceeding was commenced*. The court reasoned that "[w]here, as here, a loan is nonrecourse, the fundamental bargain between the lender and the borrower is that the lender agrees to conditionally forego his right to seek money damages, provided that the borrower respects certain covenants. To hold that in the context of a nonrecourse loan the election of remedies bars an action on the debt even where the springing recourse event occurred after the commencement of the foreclosure proceeding would effectively transform the lender's conditional waiver into an absolute one, contrary to the intent of the parties….The court is unwilling to upend the universe of real estate finance for …[the guarantor's] sake."

The *172 Madison* decision clarifies New York's "one form of action" rule. It will not serve to protect a nonrecourse carveout guarantor from liabilities arising as a result of intentional "bad acts" that occur after the initiation of a foreclosure action. While this is a decision at the trial level and is subject to appeal, the court's reasoning is persuasive and should point the way for resolution of the "one form of action" problem in proceedings for the foreclosure of mortgages securing non-recourse loans backed up by bad boy guarantees. The *172 Madison* decision offers a foreclosing lender potential new protections and resolution strategies if a borrower files for bankruptcy during a pending foreclosure, and it acts as a disincentive to borrowers/guarantors who may seek to delay a foreclosure sale by commencing a bankruptcy proceeding subsequent to a lender pursuing foreclosure remedies. <

1 Real Property Actions and Proceedings Law Section 1301(3)

2 *172 Madison (N.Y.) LLC v. NMP-Group LLC et al*, 2013 WL 5509141 (NY Sup. Ct. Oct. 3, 2013)

TITLE INSURER DEFENSE OBLIGATIONS, *CONTINUED FROM PAGE 6*

MORTGAGE DEBT VS. MORTGAGE LIEN

In title insurer friendly jurisdictions, courts have drawn another distinction in order to further limit defense obligations. In those states, if there is an issue with the underlying debt, as opposed to the mortgage, itself, courts have used a "two species" argument to note that a defect in the underlying debt (for example, a forged promissory note) does not create a defect in the security instrument securing such debt (the mortgage recorded to secure the forged note). Title insurance companies insure the validity of the mortgage lien and not the validity of the underlying mortgage debt. In *Deutche Bank National Association, Trustee v. First American Title Insurance Company*, the Massachusetts Supreme Judicial Court recently employed this reasoning to hold that a title insurance company did not have to pay the defense costs required to defend an action brought against the trustee of a mortgage pool. The mortgage pool trustee had acquired a plaintiff's mortgage from the originating lender. The plaintiff claimed that her promissory note was obtained by the originating lender through predatory lending practices. The court stated that the substance of the complaint is concerned with the validity of the underlying loan and not "whether the mortgage was improperly executed, improperly recorded or otherwise procured with fraud" and, therefore, the allegations of the complaint fell outside the scope of the policy and the title insurance company had no duty to defend the action.

The rationale for this distinction is a practical one. It is the lender, and not the title insurance company, that is in the best position to ensure that the underlying debt is valid. Practically, title insurance companies are not involved with the creation of the underlying debt and have limited knowledge with respect to its origins. Lenders have control over the creation of the underlying debt. Therefore, under the rationale followed by the court, it is the lender and not the title insurance company, who ought to bear the risk of loss if the underlying debt is determined to be invalid.

CONCLUSION

Whether or not a title insurance company has a duty to defend only title-related claims that are expressly covered by a title insurance policy or whether a title insurance company must defend all claims brought in a single proceeding (both covered and non-covered) varies from state to state. Before making a defense claim under a title policy, owners and lenders should review the applicable law. Determining the required allocation of defense responsibilities in advance will save time and money and allow counsel to work out a coordinated strategy for defense of all claims. <

FANNIE MAE AND FREDDIE MAC, *CONTINUED FROM PAGE 1*

incomes of $10.1 billion and $5.0 billion respectively for the second quarter of 2013, the companies' sixth and seventh consecutive quarterly profits respectively.

With respect to multifamily housing, FHFA's current goal is to contract the GSEs' market presence and simplify their operations. FHFA's 2013 Conservatorship Scorecard released in March of this year included a goal of reducing the volume of new multifamily business by 10 percent compared to 2012. FHFA expects to achieve this reduction through a combination of increased pricing, more limited product offerings and stronger underwriting standards. FHFA's declared intention of reducing the GSEs' multifamily mortgage activities has triggered some warnings of higher capital costs, given concerns in the industry that private sector lenders are not willing or able at this time to increase their multifamily lending to meet the demand, but there are other indications that the effect may be limited to weaker properties and markets.

On August 9, 2013, FHFA announced that it was seeking public input on ways to reduce the GSEs' multifamily market presence, including but not limited to, restrictions on available loan terms; simplification and standardization of loan products; limits on property financing (including loan amount limits and limits on maximum rents that could be utilized in underwriting); and limits on business activities. In its announcement FHFA suggested various limitations that might be imposed to contract the GSEs' activities and specifically asked for input as to whether banks, commercial lenders and other private capital sources would fill any market gaps resulting from such contraction.

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OPTIONS FOR REFORM

There is broad consensus that the GSEs will not return to their previous corporate form. The Administration has indicated that President Obama "strongly supports comprehensive finance reform" and that the preferred course of action is to wind down the GSEs, but it has not proposed a plan of its own to do so.

Two bills recently introduced in Congress illustrate alternative visions of a housing finance system to replace the GSEs. On June 25, 2013, Senators Bob Corker (R-TN) and Mark Warner (D-VA) introduced S.1217, the "Housing Finance Reform and Taxpayer Protection Act." A bipartisan group of five senators co-sponsored the bill. Under the bill, over the course of five years, FHFA and the GSEs would merge into the Federal Mortgage Insurance Corporation (FMIC), a new independent federal agency. The FMIC would offer an explicit "backstop" government guaranty and would purchase and securitize single and multifamily mortgage portfolios. Mortgage originators would have access to the backstop guaranty in exchange for payment of assessed guaranty fees. The investor would be required to assume a 10 percent risk of loss; the remaining 90 percent of risk would be covered by the FMIC from a mortgage insurance fund derived from the assessed fees. Underwriting criteria for single family loans would include a 5 percent downpayment requirement. In place of the affordable housing goals that the GSEs are currently required to meet, the bill provides for assessment of a separate fee of five to ten basis points, to be allocated to two existing funds: 80 percent of such fees would be allocated to the National Housing Trust Fund, which is administered by HUD and is used to finance affordable housing; and 20 percent of the fees would be allocated to the Capital Magnet Fund, which is administered by the Treasury Department and used for housing, community development and economic revitalization.

Under the Corker-Warner Bill, all of the GSEs' existing functions and activities relating to their multifamily guarantee business would be transferred to the FMIC.

A more conservative vision is embodied in H.R. 2767, the "Protecting American Taxpayers and Homeowners Act of 2013," which was introduced in the House on July 22, 2013, and is being championed by Jeb Hensarling (R-TX), the chairman of the House Committee on Financial Services. Under the Hensarling bill, which was approved by the committee on July 24, 2013, by a party-line 30-27 vote, after the GSEs are wound down there would be no federal guaranty.

PROGNOSIS FOR CHANGE

Recently, Tim Johnson (D-SD), chairman of the Senate Banking Committee, stated that his committee plans to complete work on GSE reform legislation by the end of the year, using the Corker-Warner bill as a baseline for discussions. The legislation to replace the GSEs which eventually emerges from Congress will likely provide a significant continuing federal role in mortgage finance, and in particular for multifamily affordable housing.

Given the fact that our multifamily housing finance "system" is in reality a mixture of governmental agencies such as the Federal Housing Administration, quasi-governmental GSEs and private sector companies (including life insurance companies, national and community banks, mortgage bankers and others), any decision about the proper role of the successor to the GSEs must take into account how the needs of each sector of the multifamily market will be met.

Banks have traditionally provided the bulk of multifamily construction loans, but are rarely a source of long-term financing. Life insurance companies lend primarily to newer, high-end properties. FHA has greatly expanded its production since 2008 to meet the demand created by the withdrawal of other lenders from the market, but it is questionable whether FHA will have the administrative capacity or budgetary authority to further increase its portfolio of insured loans. These and other existing sources of multifamily finance, taken together, are not sufficient to meet all of the need for multifamily housing loans—particularly for older properties and affordable housing projects—without the GSEs or other similar governmental support.

The GSEs have performed several critical roles in multifamily finance—as a backstop when other financing sources have left the market, as a dependable source for refinancing existing multifamily loans (which, unlike single family loans, typically have terms of only seven to 10 years), and as a financing source for underserved markets, including developments located in smaller housing markets and affordable housing projects. Other existing financing sources—FHA, banks and other lenders—cannot be expected to meet these needs for the foreseeable future. Accordingly, the legislation to wind down the GSEs must ensure that whatever new institution is created to replace the GSEs will have the mandate and the capacity to continue the GSEs' lead role in financing multifamily housing. <

PRO-DEVELOPER DECISION, *CONTINUED FROM PAGE 2*

THE DISTRICT'S CONDITIONS UNDERMINED THE FRAMEWORK OF NOLLAN AND DOLAN

In both *Nollan* and *Dolan*, the exactions required the developer to grant real property for public use subsequent to the issuance of the permit. Koontz, however, claimed that the timing of the exaction should not be relevant as a condition precedent or subsequent to a permit's issuance and that the requirement to pay cash should be not be treated differently from exactions of real property.

The court determined that *Nollan* and *Dolan* apply where an application is denied because an applicant is unwilling to comply with a condition that would require the applicant to give the government a property interest. The court's rationale was that there is no significant difference between a government imposing a condition precedent and a condition subsequent. In both cases, the government has the potential of leveraging its permitting power to force a person to give up the right to just compensation.

The court also ruled that *Nollan* and *Dolan* apply to situations where the government seeks only a monetary exaction as part of a conditional permit. The court has previously held that the Takings Clause does not apply to government-imposed financial obligations that "do not operate upon or alter an identified property interest" (*Eastern Enterprises v. Apfel* 1998). Here, however, the court held that the demand for money at issue "burdened petitioner's ownership of a specific parcel of land." The direct link between the district's "demand" and a specific parcel of land was sufficient to trigger *Nollan* and *Dolan*. The dissent did not agree that the district's "suggestion" that Koontz pay for offsite mitigation affected "a specific and identified property or property right."

The issue of whether Koontz may be eligible for some remedy for the taking was remanded back to Florida, as the suit was brought under a Florida statute that permits monetary damages. The court did not answer the question of whether under federal law violation of the Takings Clause would result in damages if no property was actually taken.

POTENTIAL IMPACTS OF THE DECISION

The court characterizes this decision as protecting property owners from a land-use permitting agency attempting to evade the limitations of *Nollan* and *Dolan* "simply by phrasing its demands for property as conditions precedent to permit approval." Similarly, the court believes that so-called monetary exactions are "functionally equivalent to other types of land-use exactions," and therefore, "must satisfy the nexus and rough proportionality requirements of *Nollan* and *Dolan*." With these protections, some experts have expressed the view that this decision will create more balance in the permit negotiations between government entities and property owners as governmental agencies will have to re-consider over-reaching conditions.

Despite the added protections for property owners, the unintended effect of this decision may be delays in the permitting process in city-planning departments across the country as governmental entities exercise more caution in an attempt to avoid violating the new *Koontz* rule. The result may be rejection of an application without explanation, instead of suggesting conditions, for fear of being sued for the suggestion.

Justice Kagan's dissenting opinion shares this more pessimistic outlook and states that the majority's decision "place[s] the courts smack in the middle of most everyday local government activity," has the ability to subject many local land-use regulations to "heightened constitutional scrutiny" and deprives local governments of "the flexibility they need to enhance their communities." It remains to be seen which of these views will prove to be correct as the practical implications of the *Koontz* decision are worked out at the local level. <

MARRIOTT CASE, *CONTINUED FROM PAGE 3*

MARRIOTT CASE

On March 30, 2012, the owner of the Eden Roc Renaissance Hotel in Miami Beach, Fla., terminated Marriott as the hotel's operator alleging mismanagement of the property and failure to capitalize on the Eden Roc brand. Marriott refused to acknowledge the termination. Thereafter, the owner sought to forcibly remove Marriott from the hotel; Marriott obtained a temporary restraining order barring the hotel's owner from removing it as Eden Roc's operator. In issuing the order, Justice Melvin L. Schweitzer ruled that the hotel management agreement was neither a personal services contract nor an agency contract. The court instead endorsed the plain language of the agreement itself, which proclaimed it to evidence an independent contractor relationship. In determining that the agreement was not a personal services contract, Justice Schweitzer noted that a personal services contract can only be one that relies on the services of a specific person or persons, and by definition cannot include an agreement which creates a long-term commercial relationship between corporate entities.

On March 25, 2013, the New York Appellate Division found in *Marriott International Inc. v. Eden Roc LLP* that the hotel management agreement between Marriott and Eden Roc was a personal services contract, overturning the injunction that prohibited Eden Roc from cancelling Marriott's management agreement. The court found that "[the] management agreement places full discretion with plaintiffs to manage virtually every aspect of the hotel. Such an agreement, in which a party has discretion to execute tasks that cannot be objectively measured, is a classic example of a personal services contract that may not be enforced by injunction."

PERSONAL SERVICE CONTRACTS

In granting the injunction, Justice Schweitzer noted that the management agreement was heavily negotiated by sophisticated parties, unlike a typical personal services contract that traditionally governs so-called "master-servant" relationships. The Appellate Division made no distinction between personal services contracts between commercial enterprises and individuals. It is a well-settled principle that a court will not order the specific performance of a contract for personal services due to the inherent difficulties in courts supervising the performance of uniquely personal labors. Further, the Thirteenth Amendment's prohibition of involuntary servitude provides a constitutional and policy-driven basis for courts to decline affirmative enforcement of personal services contracts.

The *Eden Roc* decision reaffirms long-standing principles as to the rules applicable for an injunction to enforce a personal services contract. Prior to the *Eden Roc* decision, other lawsuits where terminating the hotel management agreement was at issue involved the use of "agency" principles as noted above. In *Eden Roc*, the court did not rely on agency principles; indeed, the court stated that it found no agency relationship. In determining that no agency relationship existed, the Appellate Division gave owners an additional means to get control of a hotel back from an operator.

WHAT IT ALL MEANS

The *Eden Roc* decision makes it clear that a hotel owner can terminate a hotel management agreement and regain control over the asset under the rules of law applicable to personal services contracts. While not creating sweeping new law per se, the *Eden Roc* decision does add another basis for seeking termination of a hotel management agreement. Under one of two theories, hotel owners can now terminate their long-term hotel management agreements if they feel there is no satisfactory way to work with their operators—either under rules governing agency or by characterizing hotel management agreements as personal services contracts.

Despite any provision to the contrary in hotel management agreements, there is such a strong public policy developed over more than a century that non-termination provisions in these contracts will be struck down. Except in unusual circumstances, an owner always has the power to terminate an agency or a personal services contract.

However, before an owner considers taking such actions, additional factors should be considered. While the *Eden Roc* decision confirms that a hotel owner has the ability to terminate a long-term hotel management agreement, the decision does not insulate an owner from economic consequences in terminating the management agreement. The *Eden Roc* decision did not address the issue of damages for a potential breach of contract; instead, it addressed the issue of control over the hotel asset and a determination of whether a manager could continue to operate the hotel against the owner's wishes. The court ruled that Marriott could not.

If an owner who terminates a hotel management agreement does not have a contractual right to terminate (such as the existence of a material breach by the operator), the owner

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MARRIOTT CASE, *CONTINUED FROM PAGE 11*

will be liable to the operator for damages, which may be substantial.

On Sept. 24, 2013, Justice Schweitzer dismissed seven claims of Eden Roc against Marriott alleging default under the hotel management agreement; however, a number of claims supporting Eden Roc's termination of the management agreement remain to be determined, including, most importantly, that Marriott failed to perform in accordance with its own "brand" standards. This latest decision has focused upon the violation of the express terms of the management agreement as a rationale for exercising the termination right thereunder. Still to be determined, however, is whether Marriott is entitled to damages as a result of the termination.

We do not see any wave of terminations being inspired by this decision. However, we do believe *Eden Roc* will be an important factor in resolving disputes between hotel owners and operators. <

RESOLVING REAL ESTATE DISPUTES, *CONTINUED FROM PAGE 4*

(e.g., the commercial rules of the AAA or the Comprehensive Arbitration Rules and Procedures of JAMS); (iii) the location of the arbitration; (iv) the applicable governing law; (v) confidentiality provisions preventing any party from disclosing the content or results of the arbitration without the consent of all parties; (vi) discovery rights and limitations; and (vii) whether the arbitrators are allowed to award attorneys' fees, punitive damages or special damages.

For many years, most arbitration provisions required parties to submit their disputes to the AAA and use the AAA Commercial Arbitration Rules. While the AAA is still popular, a growing number of parties opt to use JAMS for commercial arbitration. The AAA is a very large organization with more than 7,000 arbitrators worldwide. In contrast, JAMS has approximately 300 full-time arbitrators. Although JAMS has fewer arbitrators to select from, it does have approximately two dozen resolution centers, including centers in New York, Washington, D.C., Boston, Chicago, Miami, Denver, Dallas, Philadelphia and several in California. The AAA also has locations throughout the United States.

Both JAMS and the AAA also have established sets of arbitration rules for commercial disputes and industry specific disputes. Copies of JAMS' and the AAA's rules and procedures are available on their websites at www.jamsadr.com/rulesclauses and www.adr.org/aaa/faces/rules, respectively. The JAMS Comprehensive Arbitration Rules and Procedures govern arbitration of disputes submitted to JAMS over $250,000, unless the parties specifically agree to use a different set of JAMS rules such as one of the industry-specific sets of JAMS rules. Parties with smaller disputes can also specifically agree to use the JAMS comprehensive rules. If parties elect to use the AAA to settle their disputes, then the AAA's Commercial Arbitration Rules will apply to any domestic commercial dispute unless the parties specifically state otherwise. Both organizations also have separate sets of arbitration rules specifically designed for construction-related disputes, which builders, architects, engineers and other parties involved in construction-related disputes can opt to use instead of the general commercial dispute rules.

In certain respects, the JAMS and the AAA rules are very similar. For example, both organizations require the arbitrators to render a final award within 30 days of the final hearing or receipt of all materials specified by the parties. Both organizations also offer expedited procedures that can limit discovery and resolve matters quickly. But there are differences between the two organizations and a client should consult with its lawyers to determine whether one may serve the client better than the other.

All of this may seem like a lot to consider, but if parties drafting a contract spend a little time figuring out the best way to resolve future disputes, it can wind up saving both parties considerable time and money in the future. <

RARE FEDERAL COURT CASE, *CONTINUED FROM PAGE 5*

However, Section 3730(e)(4) of the False Claims Act bars federal court jurisdiction in *qui tam* actions when the relevant information on which the claims are based has already entered the public domain and the purported "whistleblower" is merely "republishing" information that was equally available to anyone else looking for it – *unless* the relator can demonstrate that he was the "original source" of the relevant information. Glenn Gardens argued that all of the information on which Rosner based his False Claims Act complaint was, in fact, publicly available through local newspaper articles and by reference to the City's own J-51 database which is maintained and available to the public through the City Department of Finance's website. Glenn Gardens also challenged Rosner's contention that he was the "original source" of the information from which his complaint was derived, since he conceded in court pleadings that his "investigative efforts" to support his allegations included calls to City agencies, review of the J-51 database and conversations with tenants at Glenn Gardens concerning their rents.

Judge Scheindlin granted Glenn Gardens' motion to dismiss the Rosner complaint, finding that the information on which the lawsuit was based was publicly available, and that Rosner was not, in any event, the original source of the information since he lacked "direct and independent knowledge" of the facts underlying his claims.[3]

B. The Government Case

The False Claims Act gives the federal government the right to intervene in and take over the prosecution of a whistleblower's *qui tam* lawsuit. After more than three years of deliberation regarding Rosner's allegations, in 2009 the Government declined to intervene in Rosner's False Claims Act case. Instead, the Government filed its own civil action against Glenn Gardens, alleging that, because of its receipt of J-51 tax benefits, Glenn Gardens was not permitted to charge unregulated market rents to its tenants and was required to refund to the Government the difference between the subsidies that would have been paid for rent stabilized rents and the subsidies that were actually paid based on market rents. Given the disparity between regulated rents and market rents, the number of subsidized tenants for whom the Government claimed overcharges and the number of years for which those alleged overcharges occurred, the case posed catastrophic exposure for Glenn Gardens.

Glenn Gardens moved for summary judgment, arguing that the City was required to terminate its J-51 benefits when it withdrew from Mitchell-Lama, and that its withdrawal from the Mitchell-Lama program therefore terminated all rent regulation that had previously applied to Glenn Gardens. Glenn Gardens placed principal reliance on a clear and unambiguous New York City regulation in effect at the time it withdrew from Mitchell-Lama which provided that the City "*shall withdraw*" J-51 tax benefits from a building when it ceases to be subject to one of the forms of rent regulation that made it eligible to receive J-51 benefits in the first place. Since rent regulation under the Private Housing Finance Law (PHFL) ceased being applicable to Glenn Gardens when it withdrew from the Mitchell-Lama program, Glenn Gardens contended that at the moment of its exit it was no longer eligible to receive benefits, the City was required to withdraw them, and Glenn Gardens could not be subject to rent stabilization as a result of receiving benefits that it was not entitled to have.

The Government also moved for summary judgment, but its arguments required a more nuanced and intricate interpretation of multiple rent statutes and regulations. It claimed, among other theories, that while Glenn Gardens was in Mitchell-Lama it became simultaneously subject to the RSL, the application of which was temporarily suspended during Mitchell-Lama regulation. When Glenn Gardens exited Mitchell-Lama, according to the Government, the building reverted to rent stabilization. The Government also argued that Glenn Gardens never ceased to be subject to rent regulation since, the moment it was no longer subject to the Mitchell-Lama regime, RSL regulation sprang into effect as a result of the building's receipt of J-51 tax benefits.

The legal issues presented to the court involved questions of purely New York State law, none of which had been ruled on by a New York State appellate court at the time the dueling motions were filed. In those circumstances, it is the federal court's duty to predict how the issues would be resolved by the New York Court of Appeals.[4] Judge Scheindlin granted Glenn Gardens' motion for summary judgment, finding, among other things, that New York City regulations required the City to withdraw J-51 benefits awarded to a building if the building ceases to be subject to rent regulation.[5] She rejected the Government's simultaneous dual regulation argument

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3 *United States of America ex rel. Edmund Rosner v. Glenn Gardens Associates, L.P., et al.*, 739 F.Supp.2d 396 (S.D.N.Y. 2010).

4 *See Windsor v. United States*, 699 F.3d 169, 177 (2d Cir. 2012).

5 *United States of America v. Glenn Gardens Associates, L.P.*, 800 F.Supp.2d 496 (S.D.N.Y. 2011).

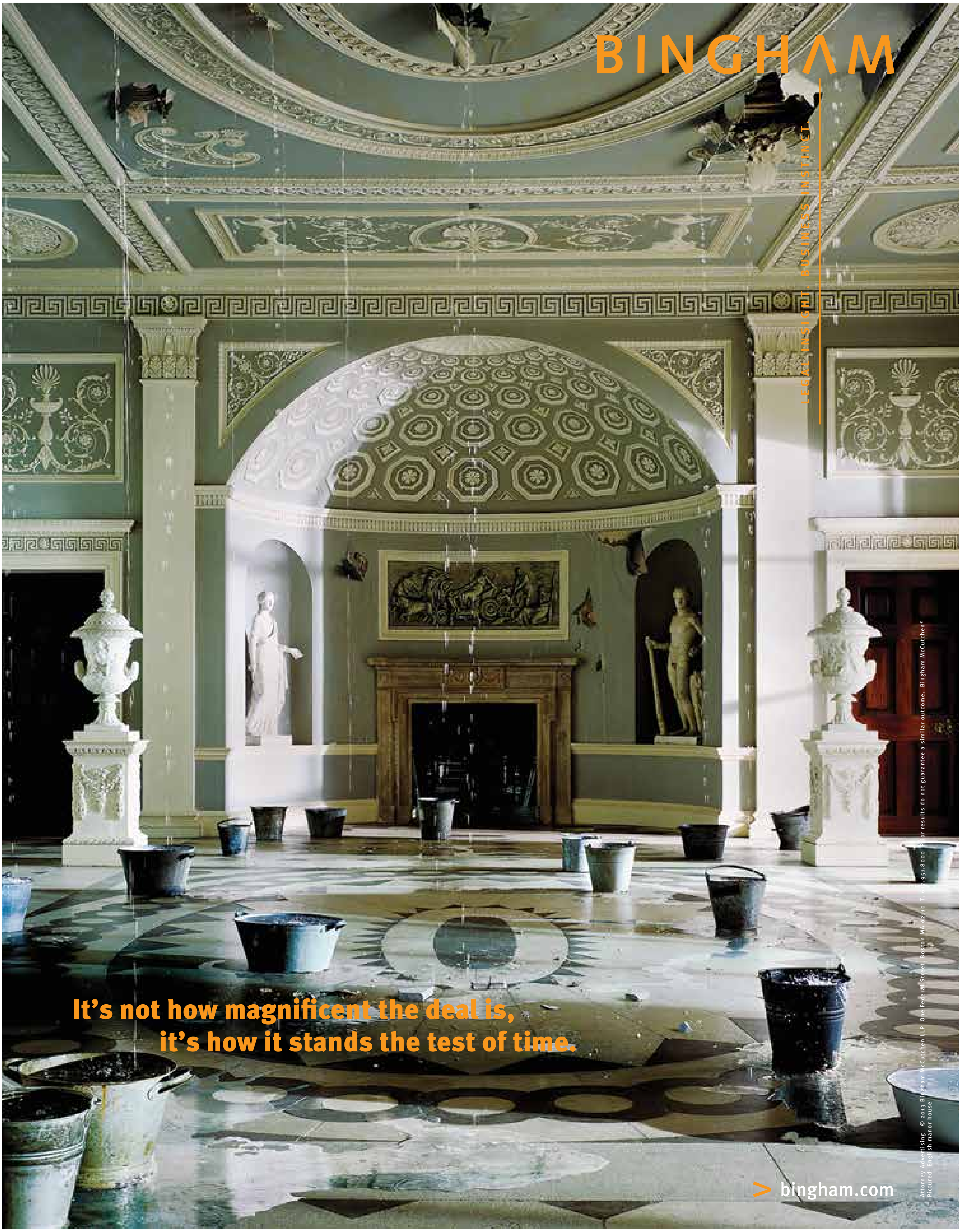
RARE FEDERAL COURT CASE, *CONTINUED FROM PAGE 13*

since the RSL, by its terms, exempts from regulation any building which is regulated under the PHFL. The Court also rejected the Government's "springing" regulation theory, holding that it was inconsistent with the mandatory language of the City regulation requiring the withdrawal of J-51 benefits at the moment Glenn Gardens ceased being subject to Mitchell-Lama rent regulation.

The Government appealed from Judge Scheindlin's order dismissing its complaint and the case was argued to the Second Circuit in May. In the interim, a New York appellate court had ruled on the identical issue in a case involving IPN.[6] That court expressed complete agreement with Judge Scheindlin's reasoning in the federal court case, and held that IPN was not subject to rent stabilization as a result of its receipt of J-51 benefits. Moreover, the New York Court of Appeals had itself denied plaintiffs' motion for leave to appeal the IPN decision. Finding no trouble predicting how New York's highest court would rule in the matter, in August, the Second Circuit affirmed the District Court in all respects,[7] concluding that Glenn Gardens did not become rent stabilized upon its exit from Mitchell-Lama. The court's decision terminated a saga which lasted for more than four years in an unusual litigation in which a federal district court was called upon to rule on what was effectively an issue of first impression arising under pure New York law. <

6 *Denza v. Independence Plaza Associates, LLC*, 95 A.D.3d 153 (1st Dept. 2012).

7 *United States of America v. Glenn Gardens Associates, L.P., et al.*, No. 11-3302-cv(L), 11-3315-cv(CON), 2d Cir., Aug. 21, 2013 (summary order).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Bingham's Real Estate Group Contacts

Practice Leaders

Richard S. Fries
New York
richard.fries@bingham.com
+1.212.705.7312

Kenneth G. Lore
Washington, D.C., and New York
k.lore@bingham.com
+1.202.373.6281 (DC) 212.705.7535 (NY)

Barry P. Rosenthal
Washington, D.C.
barry.rosenthal@bingham.com
+1.202.373.6078

Frank A. Appicelli
Hartford
frank.appicelli@bingham.com
+1.860.240.2984

Richard A. Toelke
Boston
richard.toelke@bingham.com
+1.617.951.8830

NEW YORK

J. Goodwin Bland
j.bland@bingham.com
+1.212.705.7572

Neil S. Cohen
n.cohen@bingham.com
+1.212.705.7322

Ferdinand J. Gallo, III
ferdinand.gallo@bingham.com
+1.212.705.7874

Todd B. Marcus
todd.marcus@bingham.com
+1.212.705.7313

Peter C. Neger
peter.neger@bingham.com
+1.212.705.7226

Vincent M. Sacchetti
vincent.sacchetti@bingham.com
+1.212.705.7302

Martin I. Siroka
m.siroka@bingham.com
+1.212.705.7503

Scott L. Stern
scott.stern@bingham.com
+1.212.705.7315

WASHINGTON, D.C.

Thomas Klanderman
thomas.klanderman@bingham.com
+1.202.373.6074

Glenn S. Miller
glenn.miller@bingham.com
+1.202.373.6764

J. Michael Pickett
michael.pickett@bingham.com
+1.202.373.6071

Jeffrey S. Scharff
jeff.scharff@bingham.com
+1.202.373.6622

Erica H. Weiss
erica.weiss@bingham.com
+1.202.373.6060

SILICON VALLEY

Carol K. Dillon
carol.dillon@bingham.com
+1.650.849.4812

SAN FRANCISCO

Camarin E.B. Madigan
camarin.madigan@bingham.com
+1.415.393.2660

Edward S. Merrill
doc.merrill@bingham.com
+1.415.393.2335

BOSTON

James L. Black, Jr.
james.black@bingham.com
+1.617.951.8754

Joanne D.C. Foley
joanne.foley@bingham.com
+1.617.951.8892

Henry S. Healy
henry.healy@bingham.com
+1.617.951.8271

Edward A. Saxe
edward.saxe@bingham.com
+1.617.951.8723

Lawrence I. Silverstein
l.silverstein@bingham.com
+1.617.951.8254

Charles L. Solomont
carl.solomont@bingham.com
+1.617.951.8996

Maurice H. Sullivan, III
skip.sullivan@bingham.com
+1.617.951.8799

HARTFORD

Mark Oland
mark.oland@bingham.com
+1.860.240.2929

R. Jeffrey Smith
jeff.smith@bingham.com
+1.860.240.2759

Offices

Beijing +1.86.10.6535.2888	Boston +1.617.951.8000	Frankfurt +49.69.677766.0	Hartford +1.860.240.2700	Hong Kong +852.3182.1700	London +44.207.661.5300	Los Angeles +1.213.680.6400
New York +1.212.705.7000	Orange County +1.714.830.0600	San Francisco +1.415.393.2000	Santa Monica +1.310.907.1000	Silicon Valley +1.650.849.4400	Tokyo +81.3.6721.3111	Washington, D.C. +1.202.373.6000