2016 Real Property Institute

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Presenter Biographies

2016 Real Property Institute

Presenter Biographies

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Donald A. Walcott received his B.A. from Pomona College in 1991 and J.D., magna cum laude, from William Mitchell College of Law in 1996. He has been a Member of the State Bar of New Mexico since October 22, 1996. He is admitted to practice in Federal Court for the District of New Mexico and the United States Court of Appeals for the Tenth Circuit. He is a long-term member of the First Judicial District Bar, the Oliver Seth American Inn of Court and the New Mexico Real Property, Probate and Trust Section. Walcott was an attorney at Scheuer, Yost & Patterson from 1996-2010 and a Shareholder from 2002-2010. He and his wife, Alison M. Walcott, started The Walcott Law Firm on January 1, 2011. The firm changed to Walcott & Henry on January 1, 2012 when Charles V. Henry joined the firm, and to Walcott, Henry & Winston, P.C. when Rachel L. Winston joined the firm on January 1, 2015. Walcott's primary practice areas have been civil litigation with a focus on commercial and real property litigation. In the past five years he has defended many homeowners in foreclosure cases. Over the past ten years, he has presented at a number of seminars on real estate title issues, title insurance issues, real estate litigation and foreclosure defense.

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John Bannerman has been practicing law for 47 years. He is AV rated by Martindale Hubble and has been listed in Best Lawyers In American for 25 years and Southwest Super Lawyers since its inception. Bannerman is currently Of Counsel with Montgomery & Andrews. He is a past Chair of the State Bar of New Mexico's Lawyer Professional Liability Committee, and has been a frequent speaker at Regional and National CLEs.

LLC Considerations for Dirt Lawyers

2016 REAL PROPERTY INSTITUTE

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LLC CONSIDERATIONS FOR DIRT LAWYERS

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INTRODUCTION

In 1977, Wyoming enacted the first limited liability company act in the United States. It then took the Internal Revenue Service more than ten years to determine that a limited liability company would be taxed as a partnership, rather than as a corporation.[1]

Now every state has adopted its own limited liability company act because, with partnership tax treatment available, the limited liability company (LLC) is a legal entity uniquely able to bring together the best features of other business forms. Properly structured and operated, an LLC's owners obtain both the "corporate" liability shield that is not available to general and limited partnerships or sole proprietors, and the pass-through taxation benefits of a partnership. Additionally, limited liability companies have a great deal of flexibility in ownership and management structure that is not available to other business entities.

New Mexico's Limited Liability Company Act (hereinafter sometimes referred to simply as "the Act") is found at NMSA §§ 53-19-1 through 53-19-74.

[1] The IRS still classifies LLCs by default as partnerships with pass-through tax treatment, i.e., with profits and losses passing through to the individual members of the LLC and not taxable to the LLC itself. However, LLCs may now elect to be taxed as if they are corporations, and may further elect to be treated as S corporations, as discussed more fully below.

I. FORMATION, LOCATION AND CONFIDENTIALITY ISSUES

A. Articles of Organization

In New Mexico, a limited liability company is formed by filing Articles of Organization with the Corporations Bureau of the Office of the New Mexico Secretary of State ("NM SOS"). It is now possible to file the Articles online, and the Corporations Bureau will process the filing within 1 to 3 days.

The Articles of Organization must contain at least the following:

1. The name of the LLC, which must contain the words "limited liability company" or "limited company" or the abbreviation "L.L.C." or "LLC" or "L.C." or "LC", and which must not be the same as the name of any New Mexico LLC or corporation or any foreign LLC or corporation qualified to do business in New Mexico. A "dba" name or "aka" name cannot be used as part of the LLC's name.

Practice Pointer: Before preparing and filing the Articles of Organization, be sure to check the availability of the chosen name by going to the NM SOS website and conducting a search. The NM SOS generally only requires a one word difference in names to approve its use in the State of New Mexico. But it is also advisable to search the website of the U.S. Patent and Trademark Office and to do a general Google search to make sure some other company in some other location is not already doing business under the same name and that your client's use of the name will not infringe on someone else's mark.

2. The term of existence of the LLC, which may be "perpetual" or limited.

3. The name and street address (not a post office box number) of the LLC's Registered Agent for service of process. This must be an address located within the State of New Mexico.

4. The street address of the LLC's principal place of business, if different from the Registered Agent's address. The principal place of business may be located outside of the State of New Mexico.

5. Whether the LLC is a single-member LLC.

6. Whether the LLC will be manager-managed rather than member-managed.

Practice Pointer: Unless the Articles of Organization vest management of the LLC in one or more managers, management of the LLC is vested in the members. *See* discussion *infra* in the next section addressing management structure.

7. The date on which the Articles of Organization are to be effective, if other than the date of filing.

8. The name(s) and (electronic) signature(s) of the organizer(s) or other authorized individual.

Practice Pointer: The organizer does not have to be a member of the LLC. Any "person", defined by the Act as "an individual, a general partnership, a limited partnership, a domestic or foreign limited liability company, a trust, an estate, an association, a corporation or any other legal entity", NMSA § 53-19-2.P., can serve as

the organizer, and any "person" can also be a member or manager of a New Mexico LLC. NMSA § 53-19-7.

The Articles of Organization do not have to identify the members or managers of the LLC, and they do not have to state the purpose or business for which the LLC is being organized. NMSA § 53-19-8.

Practice Pointer. For a variety of wholly legitimate reasons, it may be desirable not to have a readily available and publicly disclosed identification of members, managers, or business purpose. When a limited liability company is formed in New Mexico, its Articles of Organization will be publicly available and searchable on the NM SOS website. Therefore, the organizer may wish to limit the contents of the Articles of Organization to the required information, and save identification of members, managers, business purpose and other matters for the LLC's operating agreement, which is not filed with the NM SOS and is thus not publicly available. By contrast, New Mexico corporations are required to disclose the identities of their directors and officers and to describe their business purpose, and most other states require disclosure of an LLC's members and managers as well.

B. Amending the Articles of Organization

In New Mexico, Articles of Organization must be amended if there is a change in the name of the LLC, or a change in whether the LLC is managed by members or managers, or a change in the LLC's period of duration. NMSA § 53-19-11.C. It is not

necessary to amend the Articles if there is a change in registered agent or the registered office address, but such changes must be reported to the NM SOS.

C. Foreign Limited Liability Companies

Limited liability companies organized in states other than New Mexico that wish to transact business in New Mexico must register with the NM SOS by filing an application for Certificate of Registration, together with a certificate of good standing issued by the appropriate official of the state where the limited liability company was originally formed, and a designation of a registered agent located within the State of New Mexico. Forms and instructions are available on the NM SOS website.

Practice Pointer: It is not necessary to register a foreign LLC if its only activities in New Mexico consist of maintaining, defending or settling any proceeding; holding membership meetings or otherwise conducting activities concerning solely its internal affairs; maintaining bank accounts; maintaining offices for exchanging or registering securities or ownership interests; selling through independent contractors; soliciting orders by mail or through employees if the orders require acceptance outside New Mexico before becoming contracts; creating or acquiring indebtedness, mortgages or other security interests in real or personal property; securing or collecting debts; transacting business in interstate commerce; conducting an isolated transaction that is completed in thirty (30) days and is not part of a course of repeated transactions of like nature; or owning a controlling interest in a corporation, or being a limited partner of a limited partnership, or being a member or manager of a limited liability company, that in turn is transacting business in New Mexico. *See* NMSA § 53-19-54.

D. Annual Fees and Reports

As of this date, New Mexico limited liability companies, unlike New Mexico corporations, are not required to pay any annual fees or file any annual or biennial reports with the NM SOS.

E. Nonprofit Limited Liability Companies

New Mexico does not differentiate between for-profit and non-profit limited liability companies. An LLC "may conduct or promote any lawful business or purpose." NMSA § 53-19-6. Unlike corporations, which must incorporate as either a "for profit" (requiring only one director) or non-profit (requiring a minimum of three directors) entity, LLCs are not required to disclose their for-profit or non-profit status, and there are no different filing requirements imposed.

II. MANAGEMENT ISSUES AND FIDUCIARY DUTIES: DRAFTING THE OPERATING AGREEMENT

A. The "Default" Rules

A New Mexico limited liability company is not required to have an operating agreement, and operating agreements are not filed with the NM SOS and are therefore not publicly available.

But if there is no operating agreement, the provisions of the New Mexico Limited Liability Company Act will govern the operation and management of the LLC by default.

So it is always advisable for the members of a limited liability company to

negotiate and enter into their own operating agreement, for at least two reasons: (1) to supplant or supplement the default provisions of the Act where desirable; and (2) to be able to submit a written, signed operating agreement to banks, landlords, title companies and other individuals and institutions that may require one before transacting business with, or loaning money or leasing/selling property to, the LLC.

Practice Pointer: Even single-member LLCs should have an operating agreement to satisfy bankers and other institutions.

A limited liability company's "operating agreement" serves the same function as a written partnership agreement for a partnership, or a written joint venture agreement for a joint venture, or bylaws for a corporation. It sets forth the manner in which the LLC will be operated, spells out who will run which aspects of the business, and defines the members' voting power and rights to distributions.

At a minimum, the operating agreement should identify the LLC's initial members and cover:

(1) capital provisions, including the members' initial contributions (both amount and nature, i.e., cash or property or services or some combination of them), whether and how additional contributions may be required from members, and whether interest will be paid on capital contributions;

(2) title to assets, specifically providing that title to all assets of the limited liability company must be held in the name of the LLC, that no member has any right to the LLC's assets or any ownership interest in them (except indirectly as a result of the

member's LLC ownership interest), and that no member has any right to partition any assets of the LLC or any right to receive specific assets in distribution from or upon liquidation of the LLC, *see* NMSA § 53-19-29;

(3) how a member's percentage ownership interest is to be determined (typically, but not always, in proportion to capital contributions);

(4) whether the LLC will be member-managed or manager-managed and, if the latter, how many managers and who they will be, what authority they have, and how they are selected and replaced;

(5) if the LLC is member-managed, whether all members are agents of the LLC with authority to bind the LLC and, if so, with what limitations (see further discussion below);

(6) voting requirements, by percentage ownership interest or by capital account or per capita, for specific matters (admission of new members, expulsion of members, disposition of assets, merger, amendment of Articles of Organization, incurring indebtedness, changing the nature of the business, declaring bankruptcy or dissolving the LLC, etc.);

(7) how profits and losses will be distributed and when, and whether the LLC may or even must pay quarterly distributions to enable members to pay their quarterly federal and state tax estimates;

(8) whether the LLC will accept its default tax classification as a partnership, or whether it elects to be taxed as a corporation, and what it will use as its fiscal year;

(9) designation of a member as the "tax matters partner" of the LLC any time the LLC has more than 10 members, or any member is an entity other than an estate or a C corporation, or any member is a nonresident alien individual, in accordance with § 6231(a)(7) of the Internal Revenue Code;

(10) how a member can withdraw or be expelled from the LLC;

(11) whether a member's interest can be transferred or assigned to someone else and, if so, what the transferee's or assignee's status will be;

(12) whether and how new members may be admitted to the LLC;

(13) "buy-sell" and right-of-first-refusal arrangements for situations where a member dies, or wishes to withdraw or sell the member's interest;

(14) whether members and managers are allowed to own interests in or work for other businesses, and any limitations on engaging in competing businesses; and

(15) alternative dispute resolution procedures, such as mediation or arbitration.

B. Management Structure

LLCs are either "member-managed" or "manager-managed." In a member-managed LLC, the members operate the LLC. In a manager-managed LLC, operations are entrusted to one or more managers who may be, but need not be, members of the LLC.

Unless the Articles of Organization or Operating Agreement specify that the LLC is manager-managed, management of the business and affairs of the LLC is vested in the members pursuant to NMSA § 53-19-15.A, "subject to any provision in the articles of

organization, an operating agreement or the Limited Liability Company Act, which vests particular management responsibilities in any member or group or class of members" (emphasis added).

In other words, an LLC is member-managed by default, but the articles and operating agreement may provide for management by one or more managers, and may further specify what particular management responsibilities are the purview of the managers, and which (if any) remain with the members.

Practice Pointer: If the managers are to receive compensation for their management services, the operating agreement should spell out with specificity what that compensation will be, and who will determine its amount.

C. Fiduciary Duties in LLCs

When we talk about "fiduciary duties" in the context of business entities such as a limited liability company (LLC), we are talking about the **duty of loyalty** and the **duty of care**:

Under the duty of loyalty, sometimes also referred to as the duty of "good faith and fair dealing", an LLC member or manager is supposed to put the interests of the LLC above personal or individual interests, act honestly in any dealings with the LLC and avoid any conflicts between the LLC's interests and their own. For example, an investment opportunity available to the LLC may not be usurped for personal gain, and the member/manager may not compete with the LLC.

The duty of care requires that members and managers act in good faith and exercise reasonable care in carrying out their obligations to, and directing the activities of, the LLC. This includes acting in a reasonably prudent manner in assessing and advising the LLC about potential transactions. Under the "business judgment rule", members or managers are typically not liable for business decisions made in good faith and with reasonable care that nonetheless turn out to adversely affect the LLC.

1. Member-Managed LLCs

As a general rule, LLC members have fiduciary duties only if the LLC is structured as a member-managed LLC where the LLC members have management responsibilities.

2. Manager-Managed LLCs

On the other hand, when an LLC is manager-managed, the members have delegated management responsibility to some other person(s) or entity. In that case, the members are merely owners/investors with no management duties, and they owe no fiduciary duties to the LLC, the other members, or anyone else.

The fiduciary duties of LLC managers and members will be set forth in the specific state's LLC statute. Some state statutes do not permit members or managers to agree to modify, change or even eliminate their fiduciary duties, while others permit changes within certain limits.

Practice Pointer: You first have to determine which state's statute governs the operation of the LLC, and then review that statute. Even if a state has adopted the so-called "Uniform" Limited Liability Company Act, nearly every state has modified it in one regard or another, either by changing or omitting provisions contained

in the Uniform Act. Several jurisdictions (but not New Mexico) have adopted the **Revised Uniform Limited Liability Company Act (RULLCA)**, including (as of this writing) California, the District of Columbia, Florida, Idaho, Iowa, Nebraska, New Jersey, Utah and Wyoming. The RULLCA enumerates specific fiduciary duties owed by managers or managing members and provides for a mechanism to limit them. RULLCA § 409(a)-(d)(2006). And effective August 1, 2013, Section 18-1104 of the **Delaware Limited Liability Company Act** was amended, at the prompting of the Delaware Supreme Court, to explicitly provide that, unless the LLC's operating agreement provides otherwise, the managers and controlling members of an LLC owe fiduciary duties of care and loyalty to the LLC and its members. Section 18-1101(c) remains the same, so parties are free in their operating agreements to expand, restrict or eliminate fiduciary duties, **"provided, that the limited liability company [operating] agreement may not eliminate the implied contractual covenant of good faith and fair dealing."**

3. New Mexico Statutory Law

Section 53-19-16 of New Mexico's Limited Liability Company Act governs the liabilities and duties of both managers and members of LLCs. Under the Act, non-managing members of an LLC are not liable for breaches of the **duty of care**, and managing-members and managers are not liable in the absence of "gross negligence or willful misconduct."

Although the Act does not specifically mention the **duty of loyalty**, it does require managers and managing members to account for profits or other benefits derived from transactions connected with the LLC, or use of company property, or use of

confidential information. Beyond that, there is no specific prohibition on self-dealing or engaging in conflict of interest transactions, not any specific requirement that members or managers execute their responsibilities according to the duty of good faith and fair dealing. And if a manager or member fails to comply with enumerated duties but the transaction is approved by a majority of disinterested members or managers or is otherwise fair to the LLC, the "safe harbor" provision contained in Section 53-19-16(D) will protect them from liability.

The New Mexico Act does not explicitly provide for a mechanism to limit or eliminate fiduciary duties owed by managers or managing members of an LLC and, as discussed below, it is questionable whether the New Mexico courts would honor such limitations even if they were agreed upon.

4. New Mexico Case Law

New Mexico courts have taken an expansive view of fiduciary duties, and have imposed fiduciary duties on mangers of LLCs and other small business entities. See, e.g., Mayeux v. Winder, 139 N.M. 235, 131 P.3d 85 (2005). Mayeux involved a land development LLC, where the plaintiff members alleged that the managing member used company funds to pay for his other development projects and personal expenses. Although the Court affirmed the lower court's decision that the managing member did not breach his fiduciary duties because there was no self-dealing or fraud, and he executed his management duties in good faith and not adversely to the LLC's best interests, the Court made it clear that self-dealing and conflict of interest transactions could amount to a breach of common law fiduciary duty even though the

New Mexico Limited Liability Company Act does not statutorily impose liability for such activities. In fact, the Curt did not even cite the Act in articulating the legal standard for imposing liability on managing members.

And see McMinn v. MBF Operating Acquisition Corp. (McMinn II), 142 N.M. 160, 164 P.3d 41 (2007) (majority shareholders of closely held corporation breached fiduciary duties by initiating merger designed to "squeeze out" minority shareholder); Peters Corp. v. N.M. Banquest Investors Corp., 144 N.M. 434, 188 P.3d 1185 (2008) (self-dealing for personal benefit constitutes a breach of fiduciary duty); Walta v. Gallegos Law Firm P.C., 131 N.M. 544, 40 P.3d 449 (2002) (defining duty as "loyalty, good faith, inherent fairness, and the obligation not to profit at the expense of the corporation"); and Jones v. Auge, 2015 NMCA 16 (N.M.App. 2014), cert. denied 345 P.3d 341 (2015) (managing shareholder of professional corporation breached fiduciary duties by overpaying himself some half million dollars in bonuses):

> We begin by defining "fiduciary duty." "The duty between shareholders of a close corporation is similar to that owed by directors, officers, and shareholders to the corporation itself; that is, loyalty, good faith, inherent fairness, and the obligation not to profit at the expense of the corporation." *Walta*, 2002-NMCA-015, ¶ 41. In other words, a fiduciary duty is "[a] duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a . . . corporate officer) to the beneficiary (such as a . . . shareholder)" and involves "a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another)." *Black's Law Dictionary* 581 (9th ed. 2009). "An act that is detrimental to the interests of someone to whom a fiduciary duty is owed[,] esp[ecially] an act that furthers the actor's own interests" is a breach of loyalty. *Id.* at 214. The common thread between these statements is the idea that a fiduciary may not promote his interests above the interests of those to whom a duty is owed.
>
> Based on this principle, we examine the record for evidence that Appellant advanced his interests at the expense of Appellees or NNMOC. Under the substantial evidence standard, we "indulge[] all reasonable inferences in support of the prevailing party." *Las Cruces Prof'l Fire Fighters v. City of Las Cruces*, 1997-NMCA-044, ¶ 12, 123 N.M. 329, 940 P.2d 177. We conclude that the evidence supports the district court's findings of breach.

5. A Final Word (or Two) About Operating Agreements

There are many sources of "form" operating agreements that practitioners can use, but it is important to review them carefully and modify and adapt them for the particular needs of the LLC and its members. For example:

Definition of Ownership: Most form operating agreements define "ownership" in terms of the members' relative capital account balances. This may be acceptable in some circumstances, but not others. In particular, beware the situation where later-admitted members may lay claim to a disproportionate share of appreciated assets contributed or acquired by the original members, whose original capital accounts will not reflect the appreciation in fair market value of, for example, real estate assets the original members contributed.

If ownership is instead defined in terms of percentage ownership, one can ignore capital accounts for ownership purposes. So long as allocations and distributions are made in accordance with ownership interests, however defined, and liquidating distributions are made first in accordance with positive capital account balances, the allocations should still have "substantial economic effect" as required by Internal Revenue Code § 704 regulations.

Quorum and Voting Requirements. Form agreements typically require a quorum of 100% of the members. Such a requirement allows dissenting or disaffected minority members to hamstring the LLC's operations. However, permitting quorums of too few members can also present problems.

Consider establishing the quorum requirement and even the voting requirement for particular issues to range somewhere between 51% and less than 100%, (perhaps 66.6% or 75% or 80%), depending on the number of members and the

distribution of ownership interests. Remember, if the LLC is manager-managed rather than member-managed, you may want the same considerations to apply to quorum and voting requirements for the managers.

Buyout Provisions. Most form agreements have very basic "right of first refusal" provisions, requiring a member who wishes to sell his interest to tender it first to the LLC itself and/or to the other members in proportion to their ownership interests and on the same terms as offered by the prospective purchaser. But also consider the wisdom of including a mandatory selling requirement, sometimes referred to as a "put" or "force out" provision, that can compel a severance of ownership when irreconcilable conflicts arise.

Authorized or Permitted Transfers. To avoid triggering "right of first refusal" provisions, members may wish to include a provision in the operating agreement giving themselves the right to transfer their ownership interests to permitted transferees, such as family members or revocable living trusts. The operating agreement then must also specify whether the transferee becomes a full substitute member with voting rights, or merely a holder of the economic interest with a right to distributions.

Voting Rights of Members Unless the articles of organization or operating agreement provide otherwise, members have the following voting rights:

1. Members who have contributed to the capital of the company have a right to vote in proportion to the value of their capital contributions, adjusted to the time the vote is taken to reflect all contributions and withdrawals by members prior to the time of the vote, NMSA § 53-19-17.A;

2. A majority vote of the members having voting power is required to amend the articles of organization or the operating agreement to approve the sale, mortgage, pledge or other hypothecation or disposition of all or substantially all of the assets of the LLC; or to approve its merger or consolidation, or, unless the LLC is manager-managed, "to approve any other action required or permitted to be approved by the members", NMSA § 53-19-17.B(1);

3. The affirmative vote of all other members is required to remove a member from membership, NMSA § 53-19-17.B(2);

4. If the LLC is manager-managed, the affirmative vote of a majority of the managers is required to decide or resolve any difference on any matter connected with carrying on the business and affairs of the LLC that falls within the scope of the managers' authority, NMSA § 53-19-17.B(3);

5. A majority vote is required to decide any other matter not vested by the articles of organization or the operating agreement within the scope of authority of one or more managers or members, NMSA § 53-19-17.B(4).

These statutory provisions can be changed or supplanted by provisions in the articles of organization and/or the operating agreement to afford different voting rights, or approval by greater than majority vote. NMSA §§ 53-19-17.A. through 53-19-17.C.

Practice Pointer: The operating agreement can spell out in great detail which members have the right to vote on very specific matters, and different voting rights can be attached to different management issues. For example, a simple majority vote might be required for day to day management issues, but a greater than majority or even

unanimous vote might be required to sell the company or significant assets, or to assess members for additional capital contributions, or to take on debt.

III. CONTRIBUTIONS TO CAPITAL

A limited liability company needs to be financed. This is usually accomplished by selling membership interests in the LLC in exchange for contributions of cash or property or services rendered, "the value of which shall be established and recorded as of the date the contribution was made . . ." NMSA § 53-19-20.A, or in exchange for a promissory note or other written promise to contribute cash or property or services in the future. Id.

Unless otherwise stated in the articles of organization or operating agreement, a member's written promise to make a contribution of cash, property or services "is not excused by reason of the member's death, disability or other inability to perform", NMSA 53-19-21.A, and may be compromised "only with the unanimous consent of the members." NMSA 53-19-21.C.

And, again except as provided otherwise in the articles or operating agreement, members have no right to withdraw any part of their capital contributions. NMSA 53-19-25.A.

The operating agreement should spell out how and whether the LLC's members may be required to make additional contributions, and specify whether such contributions are deemed capital contributions or loans to the LLC.

For example, the operating agreement might provide that members are not required to make additional capital contributions and that any additional contributions

made by any or all of them will be loans. Or the operating agreement might provide to the contrary: that members will be required to make additional capital contributions if the members so vote. Penalties for failure to make the additional contribution, such as reducing or eliminating the non-contributing member's proportionate ownership interest, may also be specified.

It is quite common for operating agreements to provide that a member may make an additional capital contribution so long as other members are notified and given the opportunity to make pro rata contributions of their own to maintain their respective ownership percentages, or to provide that all members must make additional pro rata capital contributions at certain times or upon the happening of certain events.

IV. DISTRIBUTIONS

A. New Mexico Statutory "Default" Rules

Unless otherwise stated in the articles of organization or operating agreement:

1. Distributions of profits and losses are to be made to members in proportion to their capital accounts, NMSA 53-19-22, including interim distributions, NMSA 53-19-23;

2. No member has a right to demand or receive any distribution in any form other than cash, NMSA 53-19-25.B.; and

3. No member can be compelled to accept a distribution of an asset in kind to the extent its distributed value would exceed the member's normal distributive share, NMSA § 53-19-25.C.

If a member dissociates from the LLC (other than pursuant to a "winding up" of the LLC's business), the dissociating member is entitled to any distribution specified in the articles or operating agreement. If there are no such provisions, the dissociating member is entitled to receive, "within a reasonable time after dissociation," the fair market value of his LLC interest as of the date of dissociation.

Practice Pointer: Again, members may override and supplant these statutory provisions by stating to the contrary in an operating agreement or in the articles of organization. In particular, as discussed below, members may wish to place restrictions on members' rights to withdraw, and specify how the "fair market value" of a member's interest will be determined, and over what period of time (months/years) that value will be paid.

B. Liability for Wrongful Distributions

The New Mexico Limited Liability Company Act defines "wrongful distributions" as those that would render the company unable to pay its debts as they become due in the usual course of business, or that would reduce the fair market value of the LLC's assets to less than the sum of its liabilities (other than liabilities to members or to secured lenders). NMSA § 53-19-26.A.

A member or manager who votes for, approves or consents to a "wrongful" distribution, or a distribution that violates the LLC's articles of organization or operating agreement, is liable to the LLC, jointly but not severally with all other members or managers so voting, for the amount of the distribution that exceeds the amount that could

have been distributed, unless the member or manager based his decision that the distribution was permissible on reasonable financial statements or other valuation methods without actual knowledge that such reliance was unwarranted. NMSA § 53-19-27.

IV. TRANSFERS, ASSIGNMENTS AND ENCUMBRANCES OF MEMBER INTERESTS

A. New Mexico Statutory Provisions

The sale or transfer of a member's individual LLC ownership interest is accomplished by an "assignment" of the interest. Except as otherwise provided in the articles of organization or operating agreement, membership interests are assignable in whole or in part, NMSA 53-19-32.A(1), but the assignee becomes a member of the LLC only if the other members unanimously consent, NMSA 53-19-33.A, in which case the member who assigns his entire interest ceases to be a member when his assignee is admitted to membership. NMSA 53-19-33.D.

Because of these default provisions in the Act, Operating Agreements should make clear the circumstances under which an ownership interest can be transferred or assigned, if at all, and to whom and whether the assignee becomes a "true" member of the LLC or whether the assignee is simply entitled to the assignor's financial interest without the other accoutrements (such as voting rights) of the assignor.

Practice Pointer: For obvious reasons, the other member(s) of the LLC may not want to have an unknown person or entity acquire true membership rights, including the right to vote and otherwise participate in management decisions. They can

protect themselves by including a provision in the operating agreement that requires a certain percentage vote or, as set forth in the Act, even a unanimous vote of the remaining members on whether to permit voluntary assignments or whether to admit an assignee as a member.

Unless otherwise provided in the articles or operating agreement, an assignment will not in and of itself dissolve the LLC, NMSA 53-19-32.A(3), and the assignor is not released from any liability he may have as a member solely as a result of the assignment. NMSA 53-19-32.A(6).

The pledge or granting of a security interest, lien or other encumbrance is not an "assignment" and does not cause the member to cease to be a member or cease to have the rights or powers of a member. NMSA 53-19-32.B.

B. Buy-Sell Provisions

It is always wise to include in the Operating Agreement a provision that entitles the LLC itself, or one or more or all of the remaining members, to purchase a withdrawing or disassociating member's ownership interest. Death, disability, divorce, or a host of other events may occur, and it is best to anticipate such events and provide a preferred outcome for those eventualities.

Typical ways to address this issue include:

1. Giving the LLC itself a right of first refusal to purchase the member's share;

2. Giving one or more or all of the remaining members the right to purchase the share pro rata or otherwise;

3. Providing a method of valuing the disassociating member's share; and

4. Setting forth a payment schedule to accommodate the LLC's cash flow and capitalization requirements.

Absent such provisions in the articles or operating agreement, the dissociating member is entitled to receive the fair market value of his LLC interest "within a reasonable time". NMSA 53-19-24. The LLC may not have sufficient liquid assets or cash flow to pay the dissociating member the lump sum fair market value of his interest. The operating agreement should set forth an agreed-upon payment schedule of months or years, to protect the financial viability of the enterprise.

Practice Pointer: Consider including a "mandatory" buyout or "put" or "force out" provision in the operating agreement in case irreconcilable operational or management differences arise and it becomes necessary to sever a member's ownership interest.

C. UCC Article 8 Considerations

Using an LLC ownership interest as collateral for a loan, and perfecting that security interest, raises issues under both Article 9 and Article 8 of the Uniform Commercial Code (UCC). Article 8 of the UCC will affect how the Article 9 rules concerning perfection, priority and restrictions on assignment work.

Article 9 divides collateral into "types", and then applies different rules on perfection and priority depending on the type. Article 9 generally classifies LLC or partnership interest as "general intangibles".

But **New Mexico law classifies LLC ownership interest as securities,** and in general the issuer of LLC interests can **invoke Article 8** to change LLC interests from "general intangibles" into "securities" for purposes of Article 9 rules.[2]

While a security interest in a general intangible can only be perfected by filing a financing statement, a security interest in a security can be perfected by several methods: (1) filing a financing statement, (2) obtaining control of the security[3], or (3) taking possession of a certificated security.

A security interest perfected by control or possession will in most cases take priority over a competing security interest perfected by filing, even if the lender perfecting by control or possession had knowledge of the competing security interest. UCC Section 9-328. So a lender can use this rule – which is only applicable to securities – to improve the priority of its security interest.

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[2] Some states specify in their statutes whether LLC interests will be treated as securities. *See, e.g.*, Mich. Comp. Laws § 450.5103 (an LLC interest is a security); Wis. Stat. § 183.1303. The New Mexico Securities Act of 1986, NMSA §§ 58-13B-1 through 57, defines "security" to include "any interest in a limited liability company." NMSA § 58-13B-2.X. Therefore, LLC ownership interests must be registered unless they fall within an exemption or are covered by the federal securities laws.

[3] A lender can obtain control of a security by taking possession of a certificated security with an effective indorsement, having the security registered in the lender's name, entering into a control agreement with the issuer of an uncertificated security, or other means described in UCC Section 8-106.

Practice Pointer: I like to include the following provision in operating agreements:

SECTION ____. CERTIFICATE OF OWNERSHIP INTEREST

__.1. *Issuance and Transfer of Certificates.* The Member's Ownership Interest shall be represented by a Certificate. An Ownership Interest which is transferred in accordance with the terms of this Agreement or the Certificate shall be transferable on the books of the Company. The Company shall issue a new Certificate in place of any Certificate previously issued if the holder of the Certificate satisfactorily proves that a previously issued Certificate has been lost, destroyed or stolen.

__.2. *Security Classification.* The Company has elected to have certificates representing ownership interests of its members classified as securities rather than general intangibles under the terms of the Uniform Commercial Code in effect in the State of New Mexico.

One of the benefits of issuing certificates to members is that they may then endorse the certificates with a Transfer on Death (TOD) provision, for estate planning purposes and as a probate avoidance technique.

A Note on "Dissociation"

The Act defines an "event of dissociation" as an event "that causes a person to cease to be a member of a limited liability company." NMSA 53-19-2.E.

The Act goes on to identify the following events as specific events of dissociation:

1. A voluntary withdrawal of a member if the LLC's articles and operating agreement permit such withdrawal or, if the LLC has perpetual existence, the articles and operating agreement do not affirmative prohibit such withdrawal, NMSA 53-19-38.A(1);

2. The member ceases to be a member due to an assignment of his entire interest and the assignee is admitted to membership in his place, NMSA 53-19-38.A(2);

3. The member is removed in accordance with the articles or operating agreement, or by vote of all the other members if he makes an assignment of his interest

(unless, again, the articles or operating agreement provide otherwise), NMSA 53-19-38.A (3).

The Act further provides that, absent contrary provisions in the articles or operating agreement, a member will cease to be a member if he makes an assignment for the benefit of creditors, files a voluntary bankruptcy petition, is adjudicated bankrupt or insolvent, dies (or, in the case of a member other than an individual person, ceases to exist), is declared incompetent or, in the case of a member that is an estate, the estate's entire interest in the LLC is distributed. NMSA 53-19-38.B.

The articles or operating agreement may provide that these do not constitute acts of dissociation, and they may also provide for other or additional acts of dissociation. NMSA 53-19-38.C.

A member who ceases to be a member is no longer entitled to vote or otherwise participate in the management or control of the LLC, or demand information, "but may, depending on the circumstances, continue to hold a limited liability company interest in such limited liability company." NMSA 53-19-38.D.

Comparing these statutory provisions to UCC Articles 8 and 9 thus raises the following issue: UCC Section 9-408 negates certain statutory restrictions on enforcement of a security interest in a general intangible, but does not apply to a security. So a lender contemplating requiring that its collateral be made a security under Article 8 needs to be sure that it is not "resuscitating" statutory provisions anti-assignment provisions that would not be effective if the collateral were treated as a general intangible under Article 9.

VI. USING LLCs IN SOPHISTICATED FINANCINGS

Mezzanine financing of real estate allows a property owner to use its equity in the property (usually held as an LLC or partnership) as collateral even if a second mortgage isn't permitted.

There are many ways to structure mezzanine financing. One way is to have the ultimate equity owners of the real estate form one LLC to own the property (let's call it "Property LLC"), and form another LLC (as a holding company) to hold the ownership interests in Property LLC (let's call it "Owners LLC"). A mortgage loan is made to Property LLC, and a mezzanine loan is made to the holding company, Owners LLC, secured by its ownership interest on Property LLC.

Mortgage lenders are typically more willing to permit this sort of mezzanine loan than a second mortgage on the real property collateral, because the mortgage lender's position may be stronger in bankruptcy court because e the mezzanine lender is not a creditor of Property LLC, the property owner, and therefore would not have a seat at Property LLC's bankruptcy proceeding.

And commercial mortgage loans originated for securitization generally strictly prohibit junior mortgage loans, while permitting mezzanine loans that meet specified criteria (such as intercreditor agreements and rating agency requirements pertaining to the property owner's ability to service the mortgage loan).

VII. BASIC TAX ISSUES

A. Partnership vs. Corporate Tax Treatment

As discussed in the introduction to these materials, the IRS "default" rule is that an LLC will be treated as a partnership for tax purposes. But it is possible for an LLC to elect to be treated as a corporation, and to make a further election to be treated as an S corporation.

B. Electing S Corporation Tax Treatment

1. Impact of Allocations and Distributions

Stock classification restrictions. An S corporation can have only one class of stock, **although it can have both voting and non-voting shares**. But there can't be different classes of investors who are entitled to different dividends or distribution rights. If you choose to issue both voting and non-voting shares, the non-voting shares must receive the same dividends or distributions as the voting shares.

But the ability to issue non-voting shares means that **we can divorce ownership from management**; that is, members can have an equal number of voting shares and thus equal votes on management and other issues, while one member can also have additional non-voting shares that entitle that member to additional profit distributions on account of those non-voting shares.

Practice Pointer: As an example, I had two custom cabinet fabricators that decided to merge. They wanted 50-50 voting rights in the new merged company. But one company was worth more than the other, so that company received additional **non-voting** shares that entitled it to extra profit distributions (but not extra votes).

Less flexibility in allocating income and loss. Because of the one-class-of-stock restriction, an S corporation cannot easily allocate losses or income to specific shareholders. Allocation of income and loss is governed by ownership shares.

Retained Earnings. Setting up your business as a Subchapter S corporation has distinct tax advantages, including that you don't have to pay corporate income taxes on your profits. But the profits of an S corporation are still taxed, **including those that become retained earnings**. If your company has significant retained earnings, that could actually make S corporation status less desirable.

When a regular corporation makes a profit in a year, it pays corporate income taxes on that profit. After-tax profit can then be paid out to the shareholders as dividends or reinvested in the company as retained earnings. A company that has been granted S corporation status by the Internal Revenue Service doesn't have to pay corporate income taxes. Instead, the profit "flows through" the company to its shareholders. The shareholders report that profit as personal income on their tax returns. If you hold, say, 60 percent of the stock in an S corporation, and the company has a profit of $50,000, you are responsible for reporting $30,000 of that as income -- and paying taxes on it.

Just like regular corporations, S corps can distribute profits to their shareholders, keep them as retained earnings or do a little of both. The difference is that the regular corporation makes this decision after it pays corporate income taxes. An S corporation doesn't pay taxes. **The shareholders pay all the taxes on the company's calendar year profit, no matter what the company does with that profit**. If the company then distributes profits to the shareholders, the distribution isn't taxable income to the

shareholders because they are already paying income taxes on the money. **But if it chooses to keep profit as retained earnings, the shareholders still pay income taxes on the money.**

This is where retained earnings can become a problem for an S corporation. **Shareholders get taxed on their percentage of the profits regardless of whether they actually receive any of those profits as a cash distribution from the company.** Reinvesting profits is how companies grow, so every dollar of retained earnings is a dollar going toward the future of the company. But it's also a dollar that the shareholders are paying taxes on. If you're the only shareholder, or if the company has only a handful of shareholders, all actively involved in the business, this may not cause trouble. But if you have a minority, "silent partner"-type investor, that person may not be thrilled at the idea of paying taxes on money he won't receive, especially if he doesn't have a say in what the company does with its profits.

Paying taxes on profit not received should be weighed against the tax benefits of S corporation status: Individual income tax rates are generally lower than corporate rates, which reduces the overall tax burden on the company and its shareholders. Also, profit distributions are untaxed. Dividends from a regular corporation, by contrast, are taxable income to shareholders -- meaning that corporate profits are effectively taxed twice. If the shareholders of a company and their tax advisers conclude that S corporation status isn't worth the hassle, a company can terminate the status on its own. Be forewarned, though, that if you give up S corporation status, you can't reapply for it for five years.

2. Implications for Drafting Operating Agreements

A lot of the "typical" provisions in form operating agreements prepared for LLCs sticking with the "default" partnership tax treatment are not suitable for LLCs electing S Corporation treatment. For example, S Corporations do not maintain capital accounts for their members, and it is not possible to have different distribution and allocation rights. So it is best to start with a form specifically designed for use by an LLC electing S Corporation treatment.

Practice Pointer: I like to state in the Recitals or Preamble to such an operating agreement that:

RECITALS:

A. The Members are entering into this agreement for the purpose of forming a limited liability company (Company) under the provisions of the Limited Liability Company Act of the State of New Mexico (the Act) in accordance with the provisions of this operating agreement.

B. The Members will make an election to have the Company classified as a corporation for federal income tax purposes, and a further election to have it taxed as an S corporation. These elections will be made immediately after the Company is formed and will be effective on the first day of the Company's first fiscal year.

In the body of the operating you will want such provisions as:

Capital Accounts. The Company will be taxed as an S corporation rather than a partnership, and as a result, capital accounts will not be maintained for the Members.

Allocation of Net Profits and Net Losses. The net profit or net loss of the Company for any fiscal year is to be allocated among the Members in proportion to the outstanding Ownership Shares (Both Voting and Non-Voting) held by each of them.

PRESERVATION OF S CORPORATION ELECTION

Consent to Revocation. No Member may consent to revocation of the Company's election to be taxed as an S corporation for federal income tax purposes unless Members holding at least 75 percent of the outstanding Ownership Shares consent to the revocation.

Limitations on Company Action. The Company may not, without approval of the Members holding at least 75 percent of the outstanding Ownership Shares, take any action that would result in its failure to qualify as an S corporation, including without limitation, the issuance of a second class of Ownership Shares, issuance of shares to more than 100 Members, or issuance of shares to a person who is not eligible to own stock of an S corporation.

Inadvertent Termination. If the Company's S corporation election is terminated and the termination is inadvertent within the meaning of I.R.C. § 1362(f), each of the Members must make any adjustments required by the Internal Revenue Service in order for the Company to be treated as if its S corporation election remained in effect. However, a Member is not required to make any adjustments that will adversely affect the Member, considering the position the Member would have been in had the Company's S corporation election not terminated, unless the Company or the other Members indemnify and hold the Member harmless against the adverse consequences. The obligations of this subsection are binding on all Members who are parties to this agreement or become Members of the Company in the future, whether or not any such Member holds Ownership Shares at the time the required adjustments are to be made.

VIII. IMPACT OF REPEAL OF TEFRA

The Bipartisan Budget Act of 2015 (H.R. 1315) (the "Act") changes how the IRS will audit and collect tax from partnerships. Effective for partnership tax years beginning after December 31, 2017, the Act repeals both the partnership audit rules of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") (i.e., Code sections 6221 through 6234) and the electing large partnership rules (i.e., Code sections 771 through 777 and 6240 through 6255). The Act replaces the TEFRA provisions with new Code sections 6221 through 6241, which, among other things, allow the IRS to assess and

collect taxes associated with audit adjustments at the partnership level, rather than flowing adjustments through to individual partners. The changes will have a significant effect on planning strategies, tax controversies, and the case law that has developed around TEFRA partnerships over the past several decades.

The Act leaves many questions unanswered and will require significant guidance to fill in the gaps in the legislation. In effect, the Act imposes an entity-level tax on partnerships

former, and prospective partners. Although the Act is not set to be effective for tax years beginning before December 31, 2017, its repercussions will likely be felt sooner because of its potential impact on how partnership interests are valued, transferred, and protected.

Partnerships Captured by the New Rules: The Act generally imposes the new partnership audit procedures on all partnerships, regardless of size. An exception is made for partnerships (or limited liability companies treated as partnerships) that have 100 or fewer partners. Such a partnership may elect out of the new audit rules, but only if the 100 or fewer partners are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or estates of deceased partners. If any of the partners is another partnership, a trust, etc., the opt-out election cannot be made. Additionally, although the existence of an S corporation as a partner does not preclude the opt-out election, each of the S corporation's shareholders is treated as a partner of the partnership for purposes of determining whether there are 100 or fewer partners. Moreover, Congress has granted the IRS and Treasury the authority to promulgate rules similar to the S corporation "look through" rule with respect to other types of entities.

To opt out of the new audit procedures, the partnership must first timely file, on an annual basis, the opt-out election on its partnership return. Second, the partnership must notify each of the partners that the election has been made. Finally, the partnership must supply to the IRS the names and taxpayer identification numbers of each of its partners, including information with respect to each S corporation shareholder treated as a partner.

Partnership-Level Tax: The Act requires, as a default rule, that the partnership itself bear the economic burden of any audit adjustments made by the IRS. Under the new Code section 6225, rather than flowing through audit adjustments and assessing individual partners, the IRS will assess the partnership for what the Act terms the partnership's "imputed underpayment." Because the tax is imposed at the partnership level, the Act adopts a form of "rough justice" to compute the amount of tax owed. Thus, the imputed underpayment is made subject to the highest corporate or individual rate in the Code during the tax year at issue.

Equally as important, under the new rules, the IRS will assess the partnership in the year of adjustment, not the year to which the adjustments relate. For example, if the IRS completes the audit of a partnership's 2018 tax year in 2022, the rules impose the liability for any adjustments made to the 2018 tax year on the partnership (and in effect its partners) in 2022. This means that current partners may be liable for erroneous tax benefits garnered by former partners.

Implications for Contesting Adjustments: Importantly, both of the exceptions to partnership-level assessment described above require swift action by the partnership—

within either 270 days of issuance of a proposed notice of partnership adjustment, or 45 days of issuance of a final notice of partnership adjustment. The timing implications of these restrictive deadlines are stark—should a partnership wish to contest an adjustment, either administratively or judicially, it will likely lose the ability to shift the assessment responsibility to the appropriate partners, and will instead be assessed directly.

For example, if the IRS issues a proposed notice of partnership adjustment that the partnership appeals administratively, and if such appeal takes longer than 270 days to resolve, the partnership will not be able to avail itself of the first exception unless the IRS consents to extend the 270 day deadline. Similarly, if the IRS issues a final notice of partnership adjustment and the partnership litigates in a pre-payment forum, then under the new rules any adverse resolution decided by a court may be assessed against the partnership, not the prior tax year partners.

Partnership Representative: New Code section 6223 requires partnerships to designate a partner or other person with a substantial presence in the United States to serve as the partnership's representative before the IRS. The designee of the partnership has the sole authority to act on behalf of the partnership. To the extent that the partnership fails to designate a representative, the IRS "may select any person as the partnership representative."

Partnerships should pay close attention to their responsibilities to designate a representative under new Code section 6223. If the partnership has failed to designate a representative, the IRS may do so, leaving the partnership with diminished control over administrative proceedings. Moreover, if a former partner has been selected as the representative and not replaced after leaving the partnership, conflicts of interest could

arise as the former partner may be unwilling to make an election under new Code section 6226 that would push adjustments from the partnership to the prior tax year partners.

Statute of Limitations: The Act changes the statute of limitations for assessments. Under prior law, the partner's assessment statute of limitations under Code section 6501 controlled, but could be held open to the extent that the period under Code section 6229 remained open (i.e., the so-called partnership statute of limitations). New Code section 6235 provides that an adjustment under the Act's new rules cannot be made three years after the later of: (i) the date the partnership filed its return; (ii) the partnership return's due date; or (iii) the date on which the partnership filed an administrative adjustment request. This period may be extended pursuant to an agreement between the IRS and the partnership.

The Act also alters the period for a partnership to file an administrative adjustment request. Consistent with current law, the Act permits a partnership to file a request for an administrative adjustment within three years after the later of: (i) the date on which the partnership return is filed; or (ii) the last day for filing the partnership return (determined without regard to extensions), but imposes two significant changes. First, new Code section 6227 provides that an administrative adjustment request may not be filed after the IRS issues a notice of administrative proceeding to the partnership (compared to current law, which allows a request to be filed prior to the issuance of a notice of final partnership administrative adjustment). Second, and perhaps most importantly, unlike current law, the extension of a partnership's assessment statute of limitations does not simultaneously extend the period to file an administrative adjustment request. Taken together, these two revisions significantly curtail a partnership's ability to

file administrative adjustment requests.

Effective Date: The Act's new partnership audit rules generally apply "to returns filed for partnership taxable years beginning after December 31, 2017." A partnership may elect, however, to have the provisions of the Act apply to returns filed for tax years beginning after the enactment of the Act and before January 1, 2018. Accordingly, taxpayers should consider whether there are planning, controversy, or other opportunities to elect early application of the new rules.

NOTES

NOTES

1031 Deferred Tax Exchange: A Commercial Real Estate Perspective

1031 Deferred Tax Exchange: A Commercial Real Estate Perspective

Cole Flanagan, CPA, MBA

Objectives

- Identify the requirements of a 1031 exchange
- Understand the process so you can stay a step ahead
- Recognize particular nuances or specific situations that need special attention or qualify as exceptions

The Deferred Tax Exchange Process

- Decide to exchange like-kind property
- Engage your professional transaction team
- Sell the relinquished property
- Identify replacement property
- Purchase replacement property

The Basics

- Section 1031 provides for the deferral of gain or loss on the exchange of like-kind property
  - Held for productive use in trade or business, or for investment

Some Excepted Assets

- Stock in trade or property held primarily for sale
- Stocks, bonds, or notes
- Interest in a partnership

Like-Kind Property

- Refers to the nature or character of the property
  - Real Property
  - Leasehold Interests
  - Undivided Interests
  - Vacation Homes
  - Oil, Gas & Minerals
  - Personal Property
  - Goodwill
  - Foreign Property

Dealer Property vs. Investment or Trade or Business

- Dealer Property
  - Held primarily for sale/resale
  - Inventory sold to customers
  - Can have both investment property and property primarily for sale
- Investment Property
  - Held for appreciation or future use
- Trade or Business Property
  - Used in taxpayer's trade or business, which should not be the sale of real estate

Both Relinquished & Replacement

- Both sides of the exchange must be held as investment or for trade or business
- Taxpayer bears the burden of proof
- Controlling factor is the purpose/intent for which the property is held

Contributing Factors

- Purpose of acquiring and holding the asset
- Length of time the asset was held
- Frequency and regularity of sales of the asset
- Ordinary business of the taxpayer
- Efforts to sell the property
  - Listing of the property with a broker

Holding Period

- Viewed by most as a primary factor
  - There is no safe harbor
  - Sales immediately before or after an exchange generally viewed as disqualifying
  - Falls back on purpose/intent and is a supplemental factor

Tax Partnership Considerations

- Parties often have different needs/goals
- Liquidate, then exchange
- Exchange, then liquidate
- Tenancy-In-Common (TIC)
- Plan early!

Tips for TICs

- TIPS:
  - Earlier the better; more defensible
  - Separately name TIC interests in the purchase agreement
  - Assign purchase agreement to TIC interests
  - 1099 separately
  - Separate closing statements

TIC Requirements

- Must have an agreement
- 15 items the IRS looks for related to a TIC and qualification for 1031 exchange
  - Must hold title as a TIC under common law
  - Limited to 35 persons
  - Cannot operate as partners, shareholders or members
  - Must have a co-ownership agreement for undivided interests

15 Requirements (cont.)

- Unanimous voting for management agreement, debt and sale; Majority voting for other actions
- Sharing of proceeds and liabilities upon sale, profits and losses, and debt
- Service contracts must renew at least annually
- Leases at FMV and no rent based on profits
- No related party debt

Forms of 1031 Exchange

- Simultaneous Exchange
- Multi-party Exchange
- Delayed Exchange
- Reverse Exchange

Delayed Exchange

- Replacement Property
- Identification Period & Exchange Period
- Identification of Replacement Property
- Exchange Agreement
- Qualified Intermediary
- Disqualified Persons

Replacement Property

- Start the process, start looking early!!
- Like-kind
- Closing during Identification Period
- Must be "substantially the same"

Identification & Exchange Periods

- 45-Day Identification Period
- 180-Day Exchange Period
  - Be mindful of tax return due dates
- Strict Compliance
  - Saturday/Sunday?
  - Holiday?
  - Extension?

Identification of Replacement Property

- In writing prior to the end of 45-day period
- 3 Methods for identification
  - 3 Property Rule
  - 200% Rule
  - 95% Rule
- Unambiguous description
  - Specify any undivided interest
- No identification or disqualification

Exchange Agreement

- Established with Qualified Intermediary
- Prior to sale of relinquished property
- Limits rights to receive, pledge, borrow or obtain rights to money before 180 days
  - Exceptions and right to receive money early

Qualified Intermediary

- Important to use a truly "qualified" QI
- Acquires and transfers relinquished property, then acquires and transfers replacement property
- Notification of assignment to QI before closing
  - Deeds directly from seller to buyer

Disqualified Persons

- Agent of the taxpayer
- Employee, attorney, accountant, investment banker/broker, real estate broker
  - Prior 2 year period
  - Exceptions:
    - Routine financial, title insurance, escrow or trust services
- Related Persons
  - Family members, shareholders, partners, members

Additional Nuances to Identify and Plan for

- Include 1031 exchange cooperation language in the purchase agreement
- Replacement property does not have to be completed
  - Timing of completion is important
- Related party trades are permitted
  - 2-year rule
- No proportioning of gain
- Allocation of value is important in a business sale (Form 8594)

Additional Nuances to Identify and Plan for

- Same taxpayer requirement
  - SMLLC and Grantor Trust
  - Community Property vs. Common Law
- Personal use of property
- Repayment of debt must be contractually connected to the sale of the property
- Seller-financing of relinquished property
  - Bring funds to closing
  - Make note in favor of QI

NOTES

NOTES

Condemnation: Key Issues in Eminent Domain

Condemnation:

Key Issues in Eminent Domain

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1. Just Compensation Cometh:

The Development of Eminent Domain Principles

A. Just Compensation

1) The Magna Carta

2) The United States Constitution

3) The New Mexico Constitution

B. Fair Market Value

1) Definition – UJI 13-711

2) Full taking – UJI 13-703

3) Partial taking – UJI 13-704

C. Highest and Best Use

1) Definition – UJI 13-714

2) Not Speculative Value – UJI 13-721

2. Damages, What Damages?

A. Damages Without a Taking

1) Temporary damages

2) Permanent damages

B. Damages in a Partial Taking

1) What is a partial taking?

2) Computation of Damages – UJI 13-705

3. The Boundary of Recovery

The Unity Rule Defines the Larger Parcel

A. Unity of Use

B. Unity of Ownership

C. Physical Contiguity

NOTES

NOTES

Two Year Post- *Bank of New York v. Romero* – Where Do We Stand?

Bank of New York v. Romero – Where Do We Stand?

Donald A. Walcott

I. Introduction.

On February 13, 2014, the New Mexico Supreme Court issued an opinion, *Bank of New York ("BONY") v. Romero*, 2014-NMSC-007, that has clarified New Mexico law regarding standing and the standard of proof necessary to foreclose on real property. The NMSC held that a foreclosing entity must demonstrate standing to foreclose **at the time it filed suit**. *Id.*, at ¶ 17. Standing to foreclose needs to be demonstrated by showing "timely ownership of the note and mortgage." *Id.* "Ownership" of the note requires an entity to show that it is a "holder in due course of" or a "person entitled to enforce" the note, as defined in Article Three of the UCC, NMSA 1978, §§ 55-3-101, *et seq.*

However, it turns out this was just the beginning of the story of *Romero* and the law governing foreclosure actions. On March 3, 2016, in *Deutsche Bank v. Johnston*, 2016-NMSC-013, the New Mexico Supreme Court clarified its holding in *Romero* that standing must be proven as of the date of the filing of a Complaint. *Id.*, at ¶ 27. However, the Court also clarified that standing in a judicial foreclosure is based on prudential considerations, and is not a jurisdictional threshhold. *Id.*, at ¶ 13. And because standing is not jurisdictional, the Court held that "a final judgment from a cause of action that may have lacked standing as a jurisdictional matter may be subject to a collateral attack, while a final judgment on any other cause of action, including an action to enforce a promissory note such as this case, is not voidable under Rule 1–060(B) due to a lack of prudential standing."

In both *Romero* and *Johnston*, the Court reversed the district court and remanded "with

instructions to vacate its judgment of foreclosure." This instruction, in each case, has resulted in disagreement at the district court level regarding how the district court should dismiss the case – with or without prejudice. *Romero* has ended up in the Court of Appeals again over this dispute, and petition for writ of certiorari is pending in the New Mexico Supreme Court.

The most recent *Romero* appeal has given rise to some interesting issues regarding the finality of judgments, when the judgment is against the party attempting to foreclose.

II. *Bank of New York v. Romero (II)*, COA #34,426.

After remand, the district court dismissed the Bank of New York's claims **with prejudice**. The bank appealed. The Court of Appeals reversed with instructions on remand to enter judgment **without prejudice**. *Id.*, at ¶ 27. The Court of Appeals reasoned that the dismissal based on a lack of standing is not a judgment on the merits, and therefore is not entitled to the presumption of precluding a subsequent suit by claim preclusion (*res judicata*). *Id.*, at ¶ 16. Because a dismissal with prejudice carries with it the presumption of preclusive effect on subsequent suit, the dismissal of a case due to lack of standing should be without prejudice. *Id.*, at ¶¶ 13, 22. The Court of Appeals left open the question of whether issue preclusion (collateral estoppel) would bar a second suit by Bank of New York against the Romeros. *Id.*, at ¶ 26. Even though the issue of standing was fully litigated through a trial, there was still a possibility that a second suit could be based on facts that occurred in the time between the dismissal of the first suit and the filing of a second suit. *Id.*, at ¶ 25. A petition for writ of certiorari has been filed and is pending.

III. Can a homeowner ever really win against a foreclosing entity?

The *Romero (II)* decision has given rise to additional issues for other courts to address. It would appear that Bank of New York will be barred by issue preclusion from re-litigating its

standing against the Romeros, based on the facts as they exist today. However, after this case is dismissed, can Bank of New York obtain yet another indorsement on the promissory note and institute foreclosure proceedings based on new facts? What does it mean for a homeowner who goes through a trial against a foreclosing entity and prevails because the foreclosing entity cannot prove it is the holder in due course of the promissory note? Can foreclosing entities continue to bring new suits as many times as they want?

These are important issues for homeowners who have managed to successfully defend against foreclosure cases. And *Romero (II)* may have a bearing on other issues regarding other types of dismissals of foreclosure cases, and in determining whether a homeowner can every really win.

A. A case for overturning *Romero (II)*.

A petition for writ of certiorari and an appellate answer brief that have been filed by counsel for the Romeros contain the legal arguments for overturning *Romero (II)* in detail. However, here's a summary of these arguments.

First, involuntary dismissals generally operate as adjudications on the merits, with limited exceptions. A trial that results in a finding that the foreclosing entity lacks standing should not be one of these limited exceptions. In fact, the Court of Appeals has recently held that a dismissal for failure to state a claim is a dismissal on the merits, entitled to preclusive effect, even when that dismissal was without prejudice. *Turner v. First New Mexico Bank*, 2015-NMCA-068, ¶ 8. As stated in *Turner*, the issue of whether a dismissal is "on the merits" depends on whether there was a "full and fair opportunity" to litigate the issue. It seems obvious that going through a trial constitutes a full and fair opportunity.

Second, the Supreme Court in *Johnston* stated that lack of standing in foreclosure cases

should be treated like a failure to state or prove a claim. The right to enforce a promissory note and mortgage is an essential element of a claim for foreclosure, and failure to prove that right at trial is a failure to prove the claim.

Third, plaintiffs in foreclosure cases will have not have to present their full case in an initial action, knowing that they can always try and try again. This is an especially dangerous precedent in foreclosure cases because foreclosing entities often file suit before knowing for sure whether they have standing to pursue a claim. This is contrary to stated policy: "A party cannot by negligence or design withhold issues and litigate them in consecutive actions." *First State Bank v. Muzio*, at ¶ 9. In the interest of the public policy of having finality for litigants, foreclosing entities should not be allowed to relitigate cases and issues that they have conclusively lost after a full and fair opportunity to litigate their claims.

B. How far does *Romero (II)* actually go?

Romero (II) certainly was a disappointment for the Romeros, who, over the past eight years, have been through a trial, an appeal to the New Mexico Court of Appeals, then the New Mexico Supreme Court, and now to another appeal. And at the end of it all, they may have to defend themselves against yet another lawsuit over the same subject matter. However, will BONY actually be able to maintain a second suit?

The Court of Appeals did not decide whether a second suit would be barred by issue preclusion. And it's possible that the next district court judge to see this case will decide that BONY is not entitled to another opportunity to prove its standing. Additionally, the statute of limitations in cases involving promissory notes is six years from the date of acceleration. N.M.S.A. 1978, § 55-3-118(a)(1992). By filing its Complaint for Foreclosure, BONY accelerated the debt. However, there is case law from other jurisdictions that indicates that the

statute of limitations may start over after a case is dismissed. This may be yet another issue for the New Mexico appellate courts.

Between issue preclusion and the statute of limitations, many homeowners who have prevailed against foreclosing entities because of a lack of standing may be able to preclude a second lawsuit.

C. So what happens after a foreclosure suit is dismissed?

When a foreclosing entity brings a foreclosure suit, the debt is accelerated and all amounts are declared due and owing. The foreclosing entity has to allege that it is the holder in due course of the promissory note and that the mortgage was properly assigned to it. What if the lawsuit is dismissed with prejudice? Do the note and mortgage cease to be enforceable against the homeowner? The following are a few scenarios that are either on appeal or have not yet been decided by an appellate court.

Scenario #1: At trial, the foreclosing entity was unable to prove standing because the promissory note was not indorsed by the original lender, and the foreclosing entity could not prove that the note was indorsed in blank by anyone with authority to indorse the note. Foreclosing entity then brings a new lawsuit, hoping to establish the indorsement on the note was done by someone with authority to do so. Shouldn't this case be barred by issue preclusion? Shouldn't it be barred by claim preclusion, pursuant to *First State Bank v. Muzio*?

Scenario #2: On a motion to dismiss, challenging a note not indorsed to the foreclosing entity, the foreclosing entity concedes the motion and does not object to an order of dismissal with prejudice. Foreclosing entity files a second suit with the same promissory note. Shouldn't this case be barred by res judicata?

Scenario #3: A case is dismissed with prejudice as a sanction because the foreclosing

entity failed to comply with an Order on a Motion to Compel discovery responses. The discovery requests sought information regarding the foreclosing entity's right to enforce the note and mortgage. The foreclosing entity continues to send account statements for the loan to the homeowner, and claims it has a right to foreclose in the event of a future default. Shouldn't the foreclosing entity be forever barred from attempting to enforce the note and mortgage?

Scenario #4: The foreclosing entity fails to prosecute for more than two years and the case is dismissed with prejudice. Shouldn't the foreclosing entity be forever barred from attempting to enforce the note and mortgage?

IV. Conclusion.

Ultimately, there should be some kind of finality to a foreclosure suit that is unsuccessful. However, in the context of foreclosure cases, depending on how the New Mexico Supreme Court rules, homeowners may be subjected to endless complaints.

Bank of New York v. Romero — Where Do We Stand?

Larry J. Montaño

I. Introduction.

"The more things change, the more they stay the same."

— Jean-Baptiste Alphonse Karr, Les Guêpes, January 1849

"It's like deja-vu, all over again."

— Yogi Berra

Jean-Baptiste Alphonse Karr and Yogi Berra mentioned in the same breath, same page. Who would have thunk it? And who would have known Mr. Karr's epigram and Mr. Berra's malapropism would so aptly describe the state of New Mexico foreclosure law only two years removed from the New Mexico Supreme Court's decision in *Bank of N.Y. v. Romero (Romero I)*, 2014-NMSC-007, 320 P.3d 1? But they do, and here is why:

A. *Romero I* and its "jurisdictional" conundrum

In *Romero I*, the Supreme Court held that the plaintiff-lender lacked any right to enforce the defendants-borrowers' promissory note or foreclose on their home mortgage. 2014-NMSC-007, ¶ 1. In support of its holding, *Romero I* made two mundane observations. One, the promissory note was neither indorsed "in blank" nor "specially indorsed" to the plaintiff-lender. *See id.* ¶¶ 10, 26. And two, the plaintiff-lender's trial testimony, tendered through a loan servicer that did not begin servicing the loan until seven months after the plaintiff had filed its foreclosure complaint, was incompetent and failed to demonstrate the means by which the plaintiff obtained the right to enforce the promissory note. *See id.* ¶¶ 30-33.

No big deal, right? After all, the Uniform Commercial Code — the statute our legislature adopted in 1961 to, as Section 55–1–103(a) states, "simply, clarify and modernize" commercial law and to "permit the continued expansion of commercial practices" — explains exactly who may enforce promissory notes. In clear and unmistakable terms, Section 55-3-301 provides that a "'[p]erson entitled to enforce' an instrument means (i) the holder of the instrument, (ii) a nonholder in

possession of the instrument who has the rights of a holder, and (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to [certain UCC enforcement provisions]." In turn, the UCC defines a "holder" to be one "in possession of a negotiable instrument that is payable either to bearer or to an identified person in possession[.]" NMSA 1978, § 55-1-201(b)(21). Because the plaintiff-lender did not qualify as a "holder" under the UCC, *Romero I* addressed whether it proved itself to be a nonholder in possession of the note who had the rights of a holder. *See Romero I*, 2014-NMSC-007, ¶ 29. Concluding that none of the plaintiff's evidence was sufficient to prove that point, *Romero I* held that the complaint should be dismissed and the judgment vacated. *See id.* ¶ 38. In words that likely seemed innocuous at the time, the Supreme Court concluded that the plaintiff lacked "standing" to enforce the note or the concomitant right to foreclose on the mortgage. *See id.*

It was the Supreme Court's use of the word "standing" — and, more critically, its context, perceived necessity, and potential ramifications — that made *Romero I* a big deal, a very big deal. In response to the plaintiff-lender's argument that the defendants-borrowers had waived their ability to challenge its right to enforce the note and foreclose on the mortgage because of their failure to cite evidentiary support in their appellate papers, the Supreme Court sought to justify its review of an allegedly unpreserved issue. *See id.* ¶¶ 14-15. But rather than simply invoking its power to hear any issue of substantial public interest as New Mexico's highest court, the Supreme Court alluded to jurisdiction, stating that "the lack of standing is a potential jurisdictional defect which may not be waived and may be raised at any stage of the proceedings, even sua sponte by the appellate court." *Id.* ¶ 15.

By ruling, or at least very strongly intimating, that standing is jurisdictional in foreclosure actions, *Romero I* set off a firestorm. It caused jurists, litigants, and counsel alike to think of and treat foreclosure actions as being *different* from other civil cases. Most immediately, it caused the New Mexico Court of Appeals, in *Deutsche Bank Nat'l Tr. Co. v. Beneficial N.M. Inc.* ("*Johnston I*"), 2014-NMCA-090, 335 P.3d 217, to reverse a plaintiff-lender's foreclosure judgment on standing grounds. To justify its ruling, *Johnston I* made two significant comments: one, "*Romero* clarified that standing is a jurisdictional prerequisite for a cause of action and must be established at the time the complaint is filed"; and, two, other courts, whose holdings "are persuasive", "have held that a lender . . . must produce the indorsed note with the complaint for foreclosure; if the lender produces the indorsed note after filing the complaint, the indorsement must be dated[.]" *Id.* ¶ 12.

In post-*Romero I* New Mexico, it thus appeared that foreclosure actions were their own peculiar species of law. Even though the New Mexico Constitution invested our district courts with general civil jurisdiction, we were told they might lack jurisdiction to hear certain foreclosure actions, of all things. Even though New Mexico adopted a notice-pleading standard over 75 years ago, we were told that an inartfully pled foreclosure complaint might doom an action to failure, no matter what was revealed through discovery, motions practice, and at trial. And even though New Mexico espoused the finality of judgments, trial courts started to vacate long-completed foreclosure judgments pursuant to Rule 1-060(B)(4) NMRA, holding they are "void" for lack of subject matter jurisdiction. Oh, what a conundrum *Romero I* had wrought.

B. *Johnston II* and the saving grace of "clarification"

The Supreme Court did not allow *Romero I* or its progeny, *Johnston I*, to remain unfettered for too long. In *Deutsche Bank Nat'l Tr. Co. v. Johnston* ("*Johnston II*"), 2016-NMSC-013, 369 P.3d 1046, the Supreme Court "clarified" its rulings in *Romero I*, as follows:

First, the Supreme Court took the "opportunity to clarify [its] statements in *Bank of New York*, 2014-NMSC-007, ¶ 17, and hold that mortgage foreclosure actions are not created by statute. Therefore, the issue of standing in those cases cannot be jurisdictional." *Johnston II*, 2016-NMSC-013, ¶ 11. The Supreme Court thus "agree[d] with Deutsche Bank that standing is not jurisdictional in this case because the cause of action to enforce a promissory note was not created by statute. Therefore, only prudential rules of standing apply to the claims in this case." *Id.* ¶ 10.

Second, the Supreme Court clarified that foreclosure actions are subject to and benefitted by New Mexico's venerable notice-pleadings standards. *See id.* ¶ 26. It denied that *Johnston I* requires that a "plaintiff conclusively establish its standing upon first filing the complaint." *Id.* The Supreme Court thus "agree[d] with Deutsche Bank that 'it is only at trial or in a dispositive motion that plaintiffs are required to prove the necessary elements of their claims,' including standing, and that a bare statement that the plaintiff holds the note may satisfy pleading standards." *Id.*

And third, in order to address the concern that lower courts were vacating long-completed foreclosure judgments pursuant to Rule 1-060(B)(4) NMRA, the Supreme Court decided to "clarify the practical implications of [its] holding that

standing is not jurisdictional in mortgage foreclosure cases." *Id.* ¶ 33. Analogizing a standing argument to a defense for failure to state a claim, the Supreme Court observed that such a challenge "may only be raised during the pendency of the action, including on appeal, but it cannot be the basis for a collateral attack on a final judgment." *Id.* (internal citations and quotations omitted). Thus, the Supreme Court concluded that "an action to enforce a promissory note such as this case[] is not voidable under Rule 1-060(B) due to a lack of prudential standing." *Id.*

C. The more things change . . . it's like deja-vu all over again

Through its three "clarifications" in *Johnston II*, the Supreme Court set the world right. Foreclosure actions are, surprise-surprise, like other civil actions. The plaintiff must comply with New Mexico's notice-pleading standards and give the defendant "fair notice" of its claims and the bases for those claims. If the plaintiff's complaint leaves something to be desired or neglects to attach a copy of the properly indorsed note, the district court is not deprived of jurisdiction to hear the matter, nor is the plaintiff doomed to failure. As in virtually all other civil actions, the plaintiff may seek leave to amend its complaint to correct pleading errors. If the plaintiff's amended pleading still falls short, as in other civil actions, the plaintiff may bridge the gap by conducting discovery (including depositions), engaging in motions practice, and ultimately presenting competent testimony at trial. And if the plaintiff obtains a judgment, whether by default, dispositive motion, or at trial, the judgment must be appealed or challenged like any other civil judgment.

And so the more New Mexico law changes, the more it stays the same. In the course of two brief but tumultuous years, *Romero I* implied that standing is jurisdictional in mortgage foreclosure actions; *Johnston I* confirmed it was and had to be established in the plaintiff-lender's foreclosure complaint itself; and, *Johnston II* gently nudged us awake and assured jurists, litigants, and counsel alike that foreclosure actions are no different than other civil actions. With the world set right, do not despair of the issues you encounter in foreclosure actions. The issues may not have been answered in the foreclosure context, but they likely have been answered in other contexts.

II. What's Next

A. *Romero II, Johnston III,* and the "remand" quandary

While *Johnston II* settled several critical issues raised in *Romero I*, it did not answer all of them, including the most vexing question of all — what happens on

remand? We now have some guidance on that issue. In the *Romero* case, on remand from the Supreme Court, the district court dismissed the plaintiff-lender's complaint "with prejudice," only to have the Court of Appeals reverse with instructions to enter the judgment "without prejudice." *See Bank of N.Y. v. Romero (Romero II)*, 2016-NMCA-091, *cert. denied* September 22, 2016, No. S-1-SC-36063. In issuing its decision, the Court of Appeals explicitly reversed "the court's ruling that the Bank 'is precluded from raising in the future the issue that it is entitled to enforce the Romeros' note and foreclosure on the Romeros' mortgage.'" *Id.* ¶ 27. Critically, the Supreme Court denied the defendants-borrowers' petition for writ of certiorari, suggesting that it either agrees with the Court of Appeals' ruling or that it wants the issue to be more fully developed before it leaps into another foreclosure morass. For now, in cases where the plaintiff-lender has been unable to prove its prudential standing, it appears that the district court should dismiss the plaintiff's foreclosure complaint, without prejudice.

Is *Romero II* conclusive on this remand issue? Not if the plaintiff-lender has its way in *Johnston III*. In that case, the plaintiff has asked the district court to allow it to reopen its case-in-chief to present additional evidence on the narrow issue of whether it was the holder when it filed suit. Unlike in *Romero I*, in *Johnston II* the Supreme Court did not instruct the district court to dismiss the foreclosure action. Rather than force the plaintiff to file a new action or force the defendants to rehash their arguments, the plaintiff claims the most expedient course is for the district court to reopen the case to resolve the lone "prudential standing" issue. *See Riggs v. Gardikas*, ¶ 8, 1967-NMSC-120, 427 P.2d 890 ("We have often said that a motion to re-open a case to permit the taking of additional testimony is addressed to the sound discretion of the trial court."); *Sena v. N.M. State Police*, 1995-NMCA-003, ¶ 12, 892 P.2d 604 ("A movant seeking permission to reopen its case must show some reasonable excuse . . . including the reason the party failed to initially offer such evidence; whether the opposing party will be surprised or unfairly prejudiced by the additional evidence; whether granting the motion would substantially delay the proceedings; the importance of the evidence to the movant's case; and whether cogent reasons exist to deny the request."). The district court has yet to rule on the plaintiff's motion, but it will almost certainly result in an appeal.

B. Curing By Amendment

In those foreclosure cases still pending in the district court, pleading defects like prudential standing should be redressable through pleading amendments. Under New Mexico law, a party may amend its pleading by leave of court or by

written consent of the adverse party. *See* Rule 1-015(A) NMRA. Leave to amend "shall be freely given when justice so requires." *Id.* "In considering a motion to amend, the trial court's exercise of discretion is limited by the policy of liberally allowing amendments to pleadings so that claims may be decided on the merits rather than on mere technicalities of procedure." *Crumpacker v. DeNaples*, 1998-NMCA-169, ¶ 17.

In New Mexico, "it is not uncommon for courts to allow jurisdictional defects to be cured by granting leave to amend the complaint." *Mitchell-Carr v. McLendon*, 1999-NMSC-025, ¶ 22. It stands to reason that non-jurisdictional defects, such as prudential standing, should be curable through pleading amendments. Indeed, there are some New Mexico cases that have allowed a plaintiff to amend its complaint to correct a standing issue. For example, in *Crumpacker v. DeNaples*, the Court of Appeals held that the complaint could be amended to add the named plaintiff's bankruptcy trustee as the real party in interest when the named party lacked standing to bring the suit. 1998-NMCA-169, ¶ 16; *see also Prot. & Advocacy Sys. v. City of Albuquerque*, 2008-NMCA-149, ¶ 17 ("[I]t is within the trial court's power to allow or to require the plaintiff to supply, by amendment to the complaint or by affidavits, further particularized allegations of fact deemed supportive of [the] plaintiff's standing.") (quoting *Warth v. Seldin*, 422 U.S. 490, 501-02 (1975)). Other courts have reached similar conclusions. *See, e.g., Sw. Ctr. for Biological Diversity v. Clark*, 90 F. Supp. 2d 1300, 1303 (D.N.M. 1999) (same); *United Union of Roofers, etc. No. 40 v. Ins. Corp. of Am.*, 919 F.2d 1398, 1402-1403 (9th Cir. 1990) ("Often a plaintiff will be able to amend its complaint to cure standing deficiencies. To deny any amending of the complaint places too high a premium on artful pleading and would be contrary to the provisions and purpose of Fed. R. Civ. P. 15").

Based on this authority and New Mexico's policy expressing a preference for resolving disputes on the merits, plaintiff-lenders may be able to amend their complaint to address "prudential standing" deficiencies so long as the requirements of Rule 1-015 are met.

C. Relation Back

If a plaintiff-lender is allowed to amend its pleading to cure any "prudential standing" deficiencies, it should be able to avoid any previously unexpired time-bar. This is true because New Mexico law permits "relation back" of pleading amendments: "Whenever the claim or defense asserted in the amended pleading arose out of the conduct, transaction or occurrence set forth or attempted to be set

forth in the original pleading, the amendment relates back to the date of the original pleading." Rule 1-015(C). Thus, relation back "is permissible where 'the nature of the claim in [the] amended complaint would remain unchanged from that asserted in the original complaint and would arise out of 'the conduct, transaction or occurrence set forth or attempted to be set forth in the original pleading,' and where the party opposing the amendment cannot show prejudice if the amendment is allowed." *Martinez v. Segovia*, 2003-NMCA-023, ¶ 24 (quoting *Chavez v. Regents of the Univ. of N.M.*, 103 N.M. 606, 610, 711 P.2d 883, 887 (1985)).

New Mexico courts have held that the purpose of statutes of limitations in preventing stale claims is not compromised by allowing relation back under Rule 1-015. *See Macias v. Jaramillo,* 2000-NMCA-086, ¶ 22; *Rivera v. King,* 1988-NMCA-093, ¶ 24. Such courts "follow[] the principle that in the interests of justice and to promote the adjudication of a case upon its merits, amendments should be freely granted and allowed to relate back to the date a complaint was originally filed so as to avoid the bar of the statute of limitations whenever the requirements of Rule 15(c) are met." *Macias,* 2000-NMCA-086, ¶ 14 (internal citations and quotations omitted); *see also Chavez,* 103 N.M. at 610, 711 P.2d at 887 (citing with approval a North Carolina Supreme Court decision permitting a plaintiff who lacked the capacity to sue to file a supplemental pleading changing her capacity which related back to the commencement of the action). Thus, if a plaintiff-lender is able to amend its pleading to cure a prudential standing defect, it should be able to avoid the running of the statute of limitations.

D. The Savings Statute

For those foreclosure cases that have been dismissed for lack of prudential standing, the plaintiff-lender might be able to avoid a time-bar by invoking New Mexico's Savings Statute. Pursuant to that statute, once a suit has been commenced, if it "fail[s] . . . for any cause, except negligence in prosecution" a second suit can be brought within six months and the second suit will be considered a continuation of the first suit. *See* NMSA 1978, § 37-1-14. "This statute has the effect of preventing the statute of limitations from barring a suit where the original suit was brought in a timely fashion but the statute ran before the second suit was filed." *Amica Mut. Ins. Co. v. McRostie*, 2006-NMCA-046, ¶ 1; *Gathman-Matotan Architects & Planners, Inc. v. State Dep't of Fin. & Admin.*, 1990-NMSC-013, ¶ 8 ("The statute is a tolling statute, which operates to suspend the running of an otherwise applicable statute of limitations when an action is timely commenced and later dismissed except when the dismissal is based on a failure to prosecute the action with reasonable diligence."). "New Mexico's policy

favoring access to judicial resolutions of disputes is embodied in Section 37-1-14." *Foster v. Sun Healthcare Grp., Inc.*, 2012-NMCA-072, ¶ 7.

To be considered a continuation under the statute, the first and second suits "must be substantially the same, involving the same parties, the same cause of action and the same right, and this must appear from the record." *Rito Cebolla Inv., Ltd. v. Golden West Land Corp.*, 1980-NMCA-028, ¶ 40; *see also United States Fire Ins. Co. v. Aeronautics, Inc.*, 107 N.M. 320, 322, 757 P.2d 790, 792 (1988) (holding that the statute of limitations on a cause of action is tolled under Section 37-1-14 "if a new suit setting for essentially the same cause of action between the same parties is commenced within six months after a dismissal except when the dismissal was based on the plaintiff's failure to pursue his claim"). Merely alleging that a second complaint filed is a continuation of the first does not necessarily invoke the extension provision of Section 37-1-14, and continuation cannot be shown by oral testimony. *See Rito Cebolla*, 1980-NMCA-028, ¶ 40.

While the Savings Statute might seem like a cure-all, there is a risk that the court could find it inapplicable. Section 37-1-14 "is intended to protect those who are diligent." *Foster*, 2012-NMCA-072, ¶ 7. Thus, Section 37-1-14 does not apply where the plaintiff was negligent in prosecuting the first suit. *See Barbeau v. Hoppenrath*, 2001-NMCA-077, ¶ 15. New Mexico courts have held that "negligence in prosecution" occurs not only where there is a failure to prosecute, but where, at the time the first suit was commenced, the plaintiff knew or has reason to know the facts which caused the suit to be dismissed. *See, e.g., Foster*, 2012-NMCA-072, ¶ 8 ("A plaintiff fails to exercise due diligence within the meaning of Section 37-1-14 when he or she brings suit in an improper forum and, at the time of filing, knows or should have reasonably known the facts that defeated that forum's jurisdiction over the plaintiff's case."); *Barbeau*, 2001-NMCA-077, ¶ 16 (holding Section 37-1-14 did not apply where plaintiff's attorney demonstrated "a clear disregard of the elementary requirements of jurisdiction" in the first suit, which rose to the level of negligence in prosecution). "[S]o long as a plaintiff has been diligent in his prosecution, a mistake based on confusion does not rise to the negligence in prosecution." *Foster*, ¶ 10.

Plaintiffs have successfully invoked Section 37-1-14 in several contexts. *See, e.g., Harris v. Singh*, 38 N.M. 47, 52-53, 28 P.2d 1 (1934) (holding that, under a prior version of Section 37-1-14, where a note holder's first suit against an individual note maker to recover under two promissory notes was dismissed and the note holder filed its amended complaint naming a partnership as the note maker after the statute of limitations had lapsed, the second suit related back to the first

suit and was not a new cause of action); *United States Fire Ins. Co.*, 1988-NMSC-051, ¶ 5 (holding that even though 2.5 years had passed when a third-party complaint was dismissed for improper joinder, the action was not barred by the two-year statute of limitations because Section 37-1-14 tolled the statute of limitations if the action was refiled within six months of the dismissal); *but see Bracken v. Yates Petroleum Corp.*, 1988-NMSC-072, ¶ 8, 107 N.M. 463, 760 P.2d 155 ("Section 37-1-14 is made inapplicable by Section 37-1-17 to any action or suit limited by separate statute."). Still, defendant-borrowers will undoubtedly argue that lenders were negligent in prosecuting their lawsuits by failing to establish their prudential standing to sue in their foreclosure complaints. How modern New Mexico courts will decide that issue remains unclear.

III. Conclusion

We are two years removed from the Supreme Court's decision in *Bank of N.Y. v. Romero*. The waters are much calmer, much cleaner, much more predictable — foreclosure cases should be treated and decided like virtually all other civil actions. But then again, this is New Mexico, where the more things appear to change, the more they really don't.

NOTES

NOTES

Engaging the Client and the Consultant: What Dirt Lawyers Need to Know to Stay Clean

ENGAGING THE CLIENT AND CONSULTANT: WHAT DIRT LAWYERS NEED TO KNOW TO STAY CLEAN

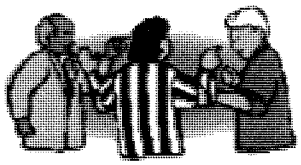
2016 Real Property Institute

John Zimmerman
Albuquerque Office

Where's the easement!

Title Search?!? What's A Title Search?

Avoiding The Conflict



WHY EVERY MATTER REQUIRES AN ENGAGEMENT LETTER

- You are asking the client to consent to certain things:
  - Rates, payment, conflict waivers.
  - These need to be resolved before the engagement begins.
- If you foresee a potential conflict or must deal with a present conflict, you must get a waiver that is "confirmed in writing."
  - While it is not required to be placed in an engagement letter, why not do it there?

THE RULES CHANGED IN 2008

- Since 2008, the Rules of Professional Conduct 16-100 Et. Seq., the Preamble to the Rules, and the Comments require a client's consent in many more circumstances.
  - Rule 16-100(B) defines the term: "Confirmed in Writing"
  - Getting consent up front in an engagement letter signed and returned by the client is the prudent approach.
  - A POTENTIAL or EXISTING client's waiver of a POTENTIAL or EXISTING Conflict of Interest must be confirmed by the client in writing. See Rules 16-107(B)(4) and 16-109(A)

THE RULES CHANGED THIS YEAR

- Rule 16-105.
  - With one exception, **whenever a fee** is charged,

> ...**the scope of the representation** and the basis or rate of the fee and expenses for which the client will be responsible **shall be communicated to the client in writing before or within a reasonable time after commencing the representation**, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall be communicated to the client in writing.

- Proposed Change to Rule 16-105 means that in most hourly rate cases, you have to have a written agreement, so why not do a full blown engagement letter.
- The Comment to the new Rule does little to explain what to do with an existing institutional client.

> When the lawyer has regularly represented a client, the lawyer and client ordinarily will have evolved an understanding concerning the basis or rate of the fee and the expenses for which the client will be responsible. In a new client-lawyer relationship, however, an understanding as to fees and expenses must be promptly established.

BASIC ELEMENTS OF AN ENGAGEMENT LETTER

- Who is the client?
- The Scope of the Work
- Who in the firm will do the work.
- What are the fees and costs the client is expected to pay, and how will they be billed and collected?

[See Materials in Binder]

OTHER STANDARD TERMS AND CONDITIONS

- Explain NM Gross Receipts Tax – if you can!
- Responsibility for payment or reimbursement of costs – what costs can be expected.
- Right to revise rates – usually on an annual basis.
- Fee Dispute Resolution Provisions
  - Reciprocal time to sue – shorten the statute of limitations
  - Arbitration – NM State Bar Fee Dispute Process or neutral traditional arbitration.
- Termination and withdrawal procedures
- Provision that by directing the firm to start work, the client accepts the terms and conditions.
- Venue, Governing law, and consent to revive information provisions.
- Explanation of Charging Lien and file reproduction/disposal procedure.
- *If you don't have the minimum required professional liability insurance you must include the required disclosure and Acknowledgement. See Rule 16-104(C).*

MORE STANDARD TERMS AND CONDITIONS

- If insurance is involved, an explanation of the conflicts that can arise with the carrier and how they will be resolved.
- If there is a potential for a conflict of interest to arise – how it will be resolved.
- If there is an existing conflict – **the waiver provision for this client**, contingent on the other client agreeing to waive the conflict as well.
  - **Rule 16-107 and 108** (Current Clients)
  - **Rule 16-109** (Former Clients)
  - **Rule 16-110** (Imputation of Conflicts)
  - **Rule 16-111** Former and Current Government Officers & Employees)
  - **The Comments and all cases citing to these Rules**

WORK IN A SIMILAR INDUSTRY PROVISION

Consent and Waiver Regarding Other Firm Clients in Similar Industry. You and the firm understand and agree that this is not an exclusive engagement, and you are free to retain any other counsel of your choosing. ***We recognize that the Firm shall be disqualified from representing any other client with interests materially and directly adverse to yours (i) in any other matter substantially related to our representation of you in this matter and (ii) with respect to any matter where there is a reasonable probability that confidential information you furnished to us could be used to your disadvantage in the subsequent matter.*** You understand and agree that, with these two exceptions, we are free to represent other clients, including but not limited to clients within your industry whose interests may conflict with yours in business transactions, litigation, or other legal matters. You agree that our representation of you in this matter will not prevent or disqualify us from representing clients adverse to you in other matters and that you consent in advance to our undertaking such adverse representations.

ABA Rule 1.09 and NM Rule 16-109 Address Conflicts With a Former Client

They both prohibit a "lawyer who has represented a client in a matter" from "representing in the same or **substantially related** matter in which that person's interests are materially adverse to the interests of the former client, unless the former client gives informed consent confirmed in writing."

Rule 16-100(L) defines "substantial" when used in reference to degree or extent to mean "...a material matter of clear and weighty importance."

What does **substantially related** mean as used in the comments?

The ABA Model Rules of Professional Conduct

These rules and comments make it clear that matters **are substantially related** if

(a) They involve the **same** transaction or legal dispute,

OR

(b) If there is otherwise a substantial risk that **confidential information** obtained by the lawyer while representing the former client will materially advance the new client's position in the subsequent matter.

Note: The Model Rule does not use the word "privileged." It uses "confidential."

The ABA Rule uses the same environmental Permit example in its Comment

ONE POTENTIALLY HELPFUL
16-109 (FORMER CLIENTS, COMMENT [2]

Buried within this comment is the following example:

> ...A lawyer who has previously represented a client in securing environmental permits to build a shopping center, would be precluded from representing the neighbors seeking to oppose rezoning of the property on the basis of environmental considerations. However, the lawyer would not be precluded, on the *grounds of substantial relationship*, from defending a tenant of the completed shopping center in resisting eviction for nonpayment of rent.

But what is a "Substantial Relationship?"

"Substantial Relationship" is not defined in the New Mexico Rules, and until 2012, no reported NM case had looked at the issue. Since then we have had three NM Supreme Court opinions which bear on the issue:

- *Mercer v. Reynolds*, filed 12/6/2012 looked at a lateral hire who was walled off from a case in which the associate had represented the other side. This case has resulted in the proposed Amendment to Rule 16-110. [Included in Materials]
- *Spencer v. Barber*, filed February 28, 2013, which addressed the extent to which intended beneficiaries could sue a lawyer for legal malpractice and how not to try and extract oneself from a developed conflict of interest.
- *Living Cross Ambulance Service v. NM PRC and American Medical Response Ambulance*, (cite) decided September 8, 2014 in which the court determined that a lawyer violated the Rules when she represented American Ambulance after she had done work for Albuquerque Ambulance.
- *Cites and Notes are in the materials.*

Living Cross provides a process that should be used to determine if there is a conflict between a present and a former client.

- Did the former client establish that the lawyer obtain confidential information in the first representation (former client) that would materially advance the [present] client's position in the subsequent matter?
- The court adopts an "optics test" to determine this issue: "Not only does the rule require disqualification when factual information was actually disclosed, the prohibition should also be extended to the 'appearance' that confidential information was disclosed."
- See Headnote 16

- In *Living Cross* the Court then states:

  Once the tribunal determines there is a substantial relationship between the former representation and the current proceedings, '**an irrebuttable presumption** arises that the former client revealed facts requiring the attorney's disqualification. ... The court need not inquire into whether the confidential information was actually revealed or whether the attorney would be likely to use the information to the disadvantage of the former client. See Headnote [17].

  - So the former client not only holds the Ace, he controls the entire deck of cards.
  - Absent an enforceable waiver obtained prior to the conflict being asserted, or one that is negotiated with the client when a conflict is raised by the client, the client will probably win.

How does this work when we use the case environmental permit example in the comments?

OBTAINING WAIVERS

- All waivers related to Conflicts of Interest must be in writing – preferably signed.
- All waivers must be based upon "informed consent." A term defined in Rule 16-100(E): "...the agreement by a person to a proposed course of conduct after the lawyer [not a paralegal] has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."
  - Each case is fact specific and what constitutes "adequate information," "material risks," and "reasonably available alternatives" may be materially different in each case.
  - If you create a boilerplate form, make certain you carefully consider whether you need to revise it.
- If you can, provide for a fair and reasonable means to resolve the dispute.

REPRESENTING MULTIPLE PARTIES IN THE SAME DISPUTE

- Clients often have a common interest or a goal.
- **Every time** you consider representing more than one party in the same matter read Rule 16-107 and the comments before you are engaged.
- You must avoid a concurrent "conflict of interest" unless you get a waiver that complies with Rule 16-107(B)(1)-(4).

- When representing more than one client you need to be cautious about settling claims, and each client must give "informed consent" to the settlement "in a writing **signed** by the client." See Rule 16-108(G).
- You may obtain a waiver for conflicts that might arise in the future. See Comment 22 to Rule 16-107. Again, provide in writing a way to resolve the conflict – if and when one arises.
- Remember to advise the common clients that the *privilege does not attach to communications between counsel and commonly represented clients.* See Rule 16-107 Comments 30 and 31.

Case Example: M'Guinness v. Johnson, 243 Cal. App. 602 (2015)

- Corporate Counsel for small construction company that had 3 share holders: McGuinness, Johnson & Stuart
- Engagement letter's description of representation was "advice and representation concerning TLC and other legal work directed by you from time to time."
- Paid a retainer and had a carry over balance.

- M'Guinness sued Johnson and TLC alleging mismanagement
- Law firm entered for Johnson and cross claimed against McGuinness, Stuart & TLC
- There was a motion filed to disqualify the firm. RESULT?

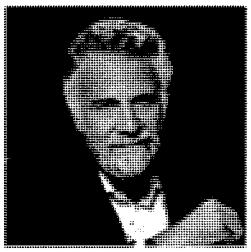
DISQUALIFIED:

- Firm represented TLC at the time the lawsuit was filed. (never terminated per engagement letter)
- The engagement was opened.
- Firm retained retainer in trust account and billed the client even though no work was performed.
- Partner was a friend of Johnson, who ran the company.

AS TIME PERMITS

- Representing the Lender – who else is your client?
- Liability to Investors when representing the Promoter
- Other?

Consultant For Hire



Qualifications? I don't know much about Real Property, but I am certain, my friend, that I am qualified because the hops in my cerveza are grown in the ground.

WHEN DOES A CONSULTANT HOLD CONFIDENTIAL INFORMATION?

Rule 11-503(B) of the NM Rules of Evidence expands the attorney client privilege to individuals other than the lawyer or her staff. It extends to:

- The lawyer's representative
- To a second lawyer representing another person in a matter of common interest
- Between a representative and the client or between the client and a representative of the client.

Who, then is a representative?

In a trial setting, communications with a non-testifying trial consultant are granted a quasi-privilege.

Rule 1-26(b)(6)(c) provides that discovery may be obtained from an expert employed in anticipation of litigation or preparation for trial and who is not expected to be called as a witness at trial **only when**:

- another party shows exceptional circumstances under which it is impracticable for the party seeking discovery to obtain facts or opinions on the same subject by other means; or
- Under Rule 1-35, which involves physical and mental examinations.
- But see *Knight v. Presbyterian Hospital Center*, 98 .M. 523, 650 P.2d 45 (NMCA 1982) that held that even work product can be discovered upon a showing of "substantial need and undue hardship."

SHIELDING A CONSULTANT

- Write a short letter like the one in the materials that makes it clear they are not being retained (at this time) as a trial testifying expert. (You can reserve the right to use them as a testifying expert).
- Reference an attachment that contains the assignment and the materials being provided. Tell them they will have to return the attachment and all copies.
- Instruct them not to list the client or the matter on any resumes, websites, social media or any other source available to the public or a search engine.

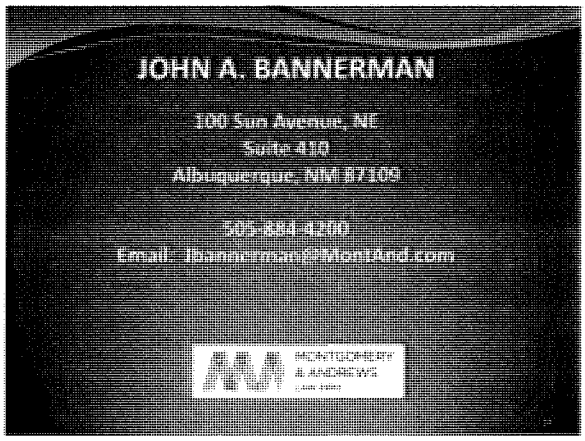
SHIELDING (CONT.)

- Tell them to call you with their initial impressions – not to prepare a report or even a draft of a report.
- Do NOT give them anything obtained directly from the client that was given to you by the client and would be otherwise protected by the privilege. If the consultant is converted into a trial expert, the privileged information will be discoverable.
- Tell them who the other parties are and instruct them that if they are contacted to decline representing an adversary without revealing who their current client is.

Water is too valuable a resource to waste on washing cars, keeping golf courses green, or taking showers.

It must only be used for truly useful and necessary purposes.

For example:
The Distillation (not dilution) of Single Malt Scotch Whiskey.



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