

DELAWARE LAW REVIEW

VOLUME 18

2022

NUMBER 1

**The Litigation Receiver: The Delaware Court of Chancery’s “Drastic,”
“Heroic” and “Extraordinary” Remedy**

Angie Priest Flaherty and Brian P. Currie

**National Real Estate Bar Guidance on U.C.C. Opinions in Commercial Real
Estate Finance Transactions**

Robert J. Krapf

**Workable Standards for Determining Allowable Rent Increases in
Manufactured Housing Communities**

Kenneth K. Baar

DELAWARE LAW REVIEW

Volume 18

2022

Number 1

TABLE OF CONTENTS

| | |
|--|----|
| The Litigation Receiver: The Delaware Court of Chancery’s “Drastic,” “Heroic” and “Extraordinary” Remedy <i>Angie Priest Flaherty and Brian P. Currie</i> | 1 |
| National Real Estate Bar Guidance on U.C.C. Opinions in Commercial Real Estate Finance Transactions <i>Robert J. Krapp</i> | 25 |
| Workable Standards for Determining Allowable Rent Increases in Manufactured Housing Communities <i>Kenneth K. Baar</i> | 35 |

The *Delaware Law Review* (ISSN 1097-1874) is devoted to the publication of scholarly articles on legal subjects and issues, with a particular focus on Delaware law to provide an overview of recent developments in case law and legislation that impacts Delaware practitioners.

The views expressed in the articles in this issue are solely those of the authors and should not be attributed to the authors' firms, places of employment, or employers, including the State of Delaware, nor do they necessarily represent positions that the authors' law firms or employers might assert in litigation on behalf of clients unless an article specifically so states. While the articles are intended to accurately describe certain areas of the law, they are not intended to be and should not be construed as legal advice.

The *Delaware Law Review* is edited and published semi-annually by the Delaware State Bar Association, 405 North King Street, Suite 100, Wilmington, Delaware 19801. (Telephone 302-658-5279.) Manuscripts may be submitted to the Editorial Board by email or hard copy using Microsoft Word and with text and endnotes conforming to *A Uniform System of Citation* (21st ed. 2020). Please contact the Delaware State Bar Association at the foregoing number to request a copy of our Manuscript Guidelines.

Subscriptions are accepted on an annual one volume basis at a price of \$40, payable in advance; single issues are available at a price of \$21, payable in advance. Notice of discontinuance of a subscription must be received by August of the expiration year, or the subscription will be renewed automatically for the next year.

Printed in the United States.

POSTMASTER: Send address changes to the *Delaware Law Review*, Delaware State Bar Association, 405 North King Street, Suite 100, Wilmington, Delaware 19801.

© Delaware Law Review, 2022. All Rights Reserved.

DELAWARE LAW REVIEW

Editorial Board

Anthony A. Rickey
Editor-in-Chief

Karen Elizabeth Keller
Research Editor

Anthony V. Panicola
Assistant Editor-in-Chief

Editors

Abby Lynn Adams
Kurt M. Heyman
Suzanne Hill Holly
Olufunke O. Leroy

Patricia C. Hannigan
Timothy M. Holly
The Honorable J. Travis Laster
Michael F. McTaggart

John A. Sensing

Advisor to the Board

The Honorable Thomas L. Ambro

Delaware State Bar Association

Charles J. Durante
President

Mark S. Vavala
Executive Director

Rebecca Baird
Publications Editor

THE LITIGATION RECEIVER: THE DELAWARE COURT OF CHANCERY'S "DRASTIC," "HEROIC" AND "EXTRAORDINARY" REMEDY

Angie Priest Flaherty and Brian P. Currie*

The Court of Chancery possesses a potent, "heroic," yet seldom used power: the authority to appoint a receiver when necessary to protect an entity or preserve property involved in litigation. This interim remedy operates as an adjunct to the claims being asserted and is not decisive on the ultimate merits of the case. The remedy is nonetheless extremely powerful, as it can temporarily strip management of its ability to operate the business or manage the assets. While the litigation receiver may appear less frequently in Delaware jurisprudence than other types of receiverships, the Court of Chancery has not hesitated to appoint litigation receivers when necessary. Nevertheless, because it is such a potent interim remedy, the Court of Chancery only deploys it in truly egregious situations or true emergencies, such as those involving fraud or gross mismanagement.

This article describes the development of the litigation receiver in Delaware jurisprudence and summarizes the principles that the Court of Chancery has developed to evaluate applications for this extraordinary remedy. To show the extraordinary nature of this relief and the relative infrequency with which it is used, this article explores the small number of reported decisions in which such relief was granted and discusses several reasons that have caused the courts to reject such an application. Drawing from the cases, this article then lays out practical considerations for serving as a litigation receiver.

The Court of Chancery possesses a potent, "heroic," yet seldom used power: the authority to appoint a temporary receiver *pendente lite*¹ when necessary to protect an entity or preserve property involved in litigation. This interim remedy operates as an adjunct to the claims being asserted and is not decisive on the ultimate merits of the case. The remedy is nonetheless extremely powerful, as it can temporarily strip management of its ability to operate the business or manage the assets. The litigation receiver contrasts with other, more familiar types of receivers such as those appointed for insolvent companies.² Although practitioners typically think of receivership and insolvency going hand-in-hand, the Delaware Court of Chancery has authority to appoint receivers for solvent entities in certain circumstances, including litigation receivers.³ While the litigation receiver may appear less frequently in Delaware jurisprudence than other types of receiverships, the

* Ms. Flaherty is a Senior Counsel and Mr. Currie is an Associate in the Wilmington office of Wilson Sonsini Goodrich & Rosati. The authors would like to thank their colleagues, Ryan Greecher and Emily Marco for their assistance in preparing this article. They would also like to acknowledge the invaluable contributions to this article from The Honorable J. Travis Laster, Vice Chancellor of the Delaware Court of Chancery.

1. Traditionally, Delaware courts have referred to receivers appointed in litigation as "receivers *pendente lite*," which means "receiver pending litigation." In an attempt to update the Latinism and make the discussion more accessible to (and less of a mouthful for) practitioners, this article uses the term "litigation receiver." We commend its use to the Delaware Court of Chancery.

2. See 8 DEL. C. § 291 (2021) (providing that a stockholder or creditor of an insolvent corporation can petition the Court of Chancery for the appointment of a receiver). For a general discussion of statutory receiverships, see J. Travis Laster, *The Chancery Receivership: Alive and Well*, 28 DEL. LAW. 12 (Fall 2010); Jack B. Jacobs, *Delaware Receivers and Trustees: Unsung Ministers of Corporate Last Rites*, 7 DEL. J. CORP. L. 251 (1982); Jack. B. Jacobs, *Receivership Practice in the Delaware Courts*, 6 DEL. J. CORP. L. 487 (1981) [hereinafter *Receivership Practice*].

3. Other situations include when a corporation fails to comply with a court order, see 8 DEL. C. § 322 (2021), or where a corporation labors under a board-level or stockholder-level deadlock, see 8 DEL. C. § 226 (2021). Parties can also seek to have a receiver appointed to liquidate a solvent corporation. See, e.g., *Tansey v. Oil Producing Royalties, Inc.*, 133 A.2d 141 (Del. Ch. 1957); *Vale v. Atl. Coast & Inland Corp.*, 99 A.2d 396 (Del. Ch. 1953). Parties may also agree contractually to the appointment of a receiver under specified circumstances. See *Dover Assocs. Joint Venture v. Ingram*, 768 A.2d 971 (Del. Ch. 2000).

Court of Chancery has not hesitated to appoint litigation receivers when necessary.⁴ Nevertheless, because it is such a potent interim remedy, the Court of Chancery only deploys it in truly egregious situations or true emergencies, such as those involving fraud or gross mismanagement.

The first part of this article describes the origins of the litigation receiver in the early twentieth century and summarizes the principles that courts developed to evaluate the applications. The second part examines the relatively few reported cases in which the court has appointed litigation receivers. The third part discusses two examples of the far more numerous cases in which the court has declined to appoint litigation receivers. The fourth part draws lessons from the cases. The fifth part of this article sets forth practical considerations for serving as a litigation receiver. The sixth part concludes.

I. THE ORIGINS AND DEVELOPMENT OF THE COURT OF CHANCERY'S EQUITABLE POWER TO APPOINT A LITIGATION RECEIVER

The role of the litigation receiver appears to have evolved from the equitable power of courts to appoint a receiver for a solvent entity, which equitable power has its roots in decisions of the English Court of Chancery. At the time of the separation of the colonies, however, the English Court of Chancery would never have appointed a receiver for a solvent company.⁵ Over the next century, the jurisprudence on both sides of the Atlantic evolved, and by the late nineteenth century, both English and American courts recognized the power of a court to appoint a receiver for a solvent company.⁶

Although courts recognized the existence of the power to appoint a receiver for a solvent entity, they exercised that power sparingly. From the start, Delaware cases emphasized that the court would appoint a receiver for a solvent corporation only upon proof of egregious facts, such as gross mismanagement, serious misconduct, or fraud.⁷ A concise summary of the rule provides as follows:

[C]ourts of equity do independent of statute appoint receivers of corporations, and through them do take possession of the property of the corporation to administer their affairs, enjoin interference by their officers, collect their assets, convert their property into money, wind up their affairs and distribute the assets among the creditors and stockholders. These powers are exercised with great caution and only as exigencies of the case appear. It will be found that the basis of such interference is gross mismanagement, positive misconduct, or other grounds showing a breach of trust on the part of the officers of the corporation.⁸

4. *Ross Holding and Mgmt. Co. v. Advance Realty Grp., LLC*, 2010 WL 3448227, at *6 (Del. Ch. Sept. 2, 2010) (“As a general matter, ‘the appointment of a receiver is an extraordinary, a drastic and ... an [sic] “heroic” remedy.’”) (quoting *Maxwell v. Enter. Wall Paper Mfg. Co.*, 131 F.2d 400, 403 (3d Cir. 1942)).

5. *Lichens Co. v. Std. Comm. Tobacco Co.*, 40 A.2d 447, 451 (Del. Ch. 1944) (“[W]hen Delaware became a state, the English Court of Chancery would not entertain a bill, filed by a minority stockholder, to wind up the affairs of a solvent corporation and appoint a receiver for that purpose, on the ground of fraud and gross mismanagement by its officers . . .”).

6. *Williamson’s Adm’r v. Washington City, Va. Midland & Great S. R.R. Co.*, 74 Va. 624, 635-36 (Va. 1881).

7. *See, e.g., Thoroughgood v. Georgetown Water Co.*, 77 A. 720, 723 (Del. Ch. 1910) (discussing the appointment of a receiver for a solvent company and stating, “It will be found that the basis of such interference is gross mismanagement, positive misconduct, or other grounds showing a breach of trust on the part of the officers of the corporation, and probably, except in rare cases, only when insolvency has resulted from such misconduct.”); *Ross Holding and Mgmt. Co. v. Advance Realty Grp., LLC*, 2010 WL 3448227, at *6 (Del. Ch. Sept. 2, 2010) (“[A] court may utilize its equitable powers to appoint a receiver only ‘when fraud and gross mismanagement by corporate officers, causing real imminent danger of great loss, clearly appears, and cannot be otherwise prevented.’”) (quoting *Drob v. Nat’l Mem’l Park*, 41 A.2d 589, 597 (Del. Ch. 1945)).

8. *Lichens Co.*, 40 A.2d at 451-52.

In this setting, the court appointed a receiver as a remedy on the merits, after the petitioner had proven its case and demonstrated that gross mismanagement, positive misconduct, or other wrongdoing was occurring.

The next step in this evolution was the recognition of the power of a court to appoint a litigation receiver for a solvent company as an interim measure pending the outcome of the litigation. In 1910, the Delaware Court of Chancery held that this authority could be deployed in a rare case for the purpose of “preserving the property [of a solvent corporation] pending the litigation which is to decide the right of the litigant parties.”⁹

By addressing a request for a litigation receiver, the court acts at an early stage of the case, before the trial on the merits and actual proof of wrongdoing. The showing that a petitioner must make to obtain a litigation receiver is thus necessarily higher, and the need for judicial discretion even greater. Commenting on such an application in 1911, the Delaware Court of Chancery noted that the appointment of a litigation receiver “is an exceedingly delicate and responsible duty, to be discharged with the utmost caution and only under special and peculiar circumstances”¹⁰

As the case law developed, certain additional parameters around the remedy emerged. First, a litigation receivership is temporary and of an “auxiliary and incidental nature,” meaning that it cannot be the only relief being sought by a plaintiff.¹¹ Second, the litigants’ dispute must involve conduct that has (and may continue) to occur—“mere apprehension of future misconduct is not enough.”¹² Third, before appointing a litigation receiver, the Court of Chancery will consider whether appointing a receiver would prevent the actual or threatened harm.¹³ Egregious behavior alone, therefore, is not enough—there must be an imminent threat of irreparable harm that the appointment of a litigation receiver can prevent. Fourth, once a receiver has been appointed, that receiver acts as an “arm” of the Court of Chancery, and the court has broad discretion over the receivership, including the receiver’s authority, its charge, the procedures that the receiver will follow, and when the receivership will end.¹⁴

II. THE RARE CASES INVOLVING APPOINTMENTS OF LITIGATION RECEIVERS

Through the years, litigants have petitioned the Delaware courts many times to appoint a litigation receiver to oversee the assets or operations of a company, but the Court of Chancery has only opted to do so on a

9. *Thoroughgood*, 77 A. at 723.

10. *Ellis v. Penn Beef Co.*, 80 A. 666, 667 (Del. Ch. 1911).

11. *Lichens Co.*, 40 A.2d at 451.

12. *Id.* at 452.

13. *Beal Bank, SSB v. Lucks*, 1998 WL 778362, at *3 (Del. Ch. Oct. 23, 1998). Earlier cases generally looked to the same factors, *e.g.*, whether there would be harm to the company and whether appointment of a receiver would be beneficial and prevent such harm. *See, e.g.*, *Whitmer v. William Whitmer & Sons*, 99 A. 428, 431 (Del. Ch. 1916) (“Where a [litigation receiver] is sought other than for an insolvent corporation, there must be shown to be a reasonable apprehension of danger and irreparable loss to the subject-matter of the suit . . .”).

14. *See Jagodzinski v. Silicon Valley Innovation Co.*, 2015 WL 4694095, at *7 (Del. Ch. Aug. 7, 2015) (noting that a court may discharge a receiver if the corporation “has attained a condition in which it can meet its obligations in the usual course of business, or that there is a reasonable prospect that its business can be successfully continued, notwithstanding any deficiency of assets.”) (quoting *Badenhausen Co. v. Kidwell*, 107 A. 297, 297 (Del. 1919)).

handful of occasions.¹⁵ In almost every case, the decision emphasizes that the relief sought was extraordinary and rarely granted.¹⁶ Like all superheroes with extraordinary powers, the members of the Court of Chancery (wearing robes instead of capes) abide by the Peter Parker Principle: With great power comes great responsibility.¹⁷ In exercising its great responsibility, the Court of Chancery will only appoint a litigation receiver to avoid serious and imminent injury. When warranted, however, the litigation receiver is a “very beneficent remedy” that “should be used boldly.”¹⁸

The situations in which the Court of Chancery has appointed a litigation receiver are highly fact-specific. The leading cases in which court has appointed a litigation receiver illustrate both the nature of the threatened harm that has warranted appointment of a receiver and how the court has fashioned the interim remedy to fit the situation at hand.

A. *Gray v. Council of Newark*¹⁹

In what appears to be the earliest Delaware case to witness the appointment of a litigation receiver, the court initially denied the appointment in favor of issuing a preliminary injunction secured by a bond. After the enjoined party failed to comply with the court’s order, however, the parties agreed to the appointment of a litigation receiver, and the court approved the stipulation.

15. *Whitmer*, 99 A. 428 (petition denied); *Moore v. Assoc. Producing & Refin. Corp.*, 121 A. 655 (Del. Ch. 1923) (petition denied); *Frantz v. Templeman Oil Corp.*, 134 A. 100 (Del. Ch. 1926) (petition granted); *Baker v. Conway*, 135 A. 596 (Del. Ch. 1926) (petition denied); *Satterthwaite v. E. Bankers’ Corp.*, 154 A. 475 (Del. Ch. 1931) (petition granted); *Salnita Corp. v. Walter Holding Corp.*, 168 A. 74 (Del. Ch. 1933) (petition denied); *Lichens Co.*, 40 A.2d 447 (petition denied); *Drob v. Nat’l Mem’l Park*, 41 A.2d 589 (Del. Ch. 1945) (petition denied); *Trincia v. Testardi*, 52 A.2d 871 (Del. Ch. 1947) (petition denied); *Vulcan-Cincinnati, Inc. v. Burnside Corp.*, 1962 WL 69570 (Del. Ch. July 13, 1962) (petition denied); *Vredenburgh v. Jones*, 1975 WL 1264 (Del. Ch. Oct. 3, 1975) (petition granted); *Farland v. Wills*, 1975 WL 1960 (Del. Ch. Nov. 12, 1975) (petition denied); *Greenfield v. Caporella*, 1986 WL 13977 (Del. Ch. Dec 3, 1986) (petition denied); *Delaware State Hous. Auth. v. Hillside Ass’n, L.P.*, 1992 WL 127503 (Del. Ch. June 9, 1992) (petition denied); *Arbitrium (Cayman Islands) Handels AG v. Johnston*, 1995 WL 606310 (Del. Ch. Oct. 6, 1995) (petition denied in connection with a Section 225 action); *Beal Bank*, 1998 WL 778362 (petition denied); *Ross Holding and Mgmt. Co. v. Advance Realty Grp., LLC*, 2010 WL 3448227, at *6 (Del. Ch. Sept. 2, 2010) (petition denied pending trial on underlying facts); *Jagodzinski v. Silicon Valley Innovation Co.*, 2012 WL 593613 (Del. Ch. Feb. 14, 2012) (petition granted); *TVI Corp. v. Gallagher*, 2013 WL 5809271 (Del. Ch. Oct. 28, 2013) (petition denied); *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*, 2019 WL 1501553 (Del. Ch. Apr. 4, 2019) (petition granted in earlier order).

16. *Berwald v. Mission Dev. Co.*, 185 A.2d 480, 483 (Del. 1962) (“The extreme relief of receivership to wind up a solvent going business is rarely granted. To obtain it there must be a showing of imminent danger of great loss resulting from fraud or mismanagement.”); *see also* *Thoroughgood v. Georgetown Water Co.*, 77 A. 720, 723 (Del. Ch. 1910) (noting that appointment of a receiver on the grounds of mismanagement will “except in rare cases” involve insolvency); *Ellis v. Penn Beef Co.*, 80 A. 666, 667 (Del. Ch. 1911); *Ross Holding*, 2010 WL 3448227, at *5; *Jagodzinski*, 2012 WL 593613, at *2 (“The appointment of a receiver, however, is an ‘extraordinary remedy.’”) (quoting *Roth v. Laurus U.S. Fund, L.P.*, 2011 WL 808953, at *5 (Del. Ch. Feb. 25, 2011)).

17. *SPIDER-MAN (Columbia Pictures 2002)*; *accord* *Cirillo Family Trust v. Moezinia*, 2018 WL 3388398, at *7 (Del. Ch. July 11, 2018) (quoting *Withrow v. Williams*, 507 U.S. 680, 716 (1993)); *see also* *Penn Beef Co.*, 80 A. at 667 (“[The appointment of a litigation receiver] is an exceedingly delicate and responsible duty, to be discharged with the utmost caution and only under special and peculiar circumstances”); *Jagodzinski v. Silicon Valley Innovation Co.*, 2015 WL 4694095, at *7 (Del. Ch. Aug. 7, 2015) (“Although the appointment and discharge of a receiver rests in the discretion of the court, the cases also suggest that such discretion should be exercised sparingly and with caution.”).

18. *Penn Beef Co.*, 80 A. at 667.

19. 79 A. 739 (Del. Ch. 1911).

The *Gray* case, a decision from 1911, involved a dispute over the operation of utilities owned by the City of Newark. Delaware's Attorney General, Andrew Gray, learned that the City Council intended to lease the city's electric and water plants to Newark Water and Electric Company, a newly formed utility company established by a former member of the City Council. On behalf of certain citizens and taxpayers, the Attorney General filed suit and obtained an order enjoining the city from completing the transaction. Before the order could be served, however, the City Council signed the lease and delivered possession of the plants.

With the preliminary injunction thwarted, the Attorney General returned to the Court of Chancery. No one moved formally for the appointment of a litigation receiver. Although the Attorney General ultimately sought to unwind the transaction and deny the utility company the right to operate the plants, everyone agreed that the plants should continue operating pending the outcome of the suit. The Attorney General therefore suggested that the facts warranted appointing a receiver to operate the plants and preserve them in their current condition pending a final hearing on the merits of the case.

The court began its analysis by confirming that it had the power to appoint a litigation receiver, provided the facts and circumstances justified it. The court noted that the power to appoint a litigation receiver was "a necessary incident to the power of granting an injunction."²⁰ The more difficult question was whether the facts of the case justified appointing a receiver. To evaluate this question, the court addressed five arguments that the Attorney General advanced in favor of appointing a receiver.

First, the Attorney General alleged that the newly formed utility company was likely insolvent and therefore potentially unable to satisfy a judgment if the plants suffered damage pending the outcome of the litigation. The court rejected this argument due to a lack of evidence of insolvency. The fact that the company had been formed just before the transaction was not enough.²¹

Second, the Attorney General argued that the interests of the citizens and taxpayers were not protected by suitable or adequate bond. The court rejected this argument because the utility company had posted a substantial bond in connection with the lease, and the Attorney General offered only speculation that the bond might be inadequate.

Third, the Attorney General noted a general concern that the finances of the parties involved would become hopelessly comingled. While acknowledging that risk, the court found that the danger of loss from any comingling was insufficiently clear to support the appointment of a litigation receiver.²²

Treating the fourth and fifth arguments together, which were that a receiver should be appointed because it would hasten the resolution of the dispute and obviate the need for the parties to use a master to settle accounts, the court remarked that no case had ever held that a receiver should be appointed simply for these reasons. Instead, given the extraordinary and severe nature of the remedy, the court commented that a litigation receiver should never be appointed except in a "clear case" that such relief is "needful."²³

After carefully considering all the facts, the court found that the appointment of a receiver was unwarranted and would involve added and unnecessary expense. The court instead issued a preliminary injunction prohibiting the utility from disposing of, abusing, injuring or altering the properties that were subject to the litigation, and requiring the utility to post a bond of \$20,000.

20. *Id.* at 739.

21. *Id.*

22. *Id.*

23. *Id.* at 740.

That ruling might have ended the matter, but the utility company failed to post the bond within ten days, as required by the court's order. At this point, the Attorney General made a formal application for the appointment of a litigation receiver, and the utility company consented to the request. The court then entered the order.²⁴

The *Gray* decision thus culminated in the appointment of a litigation receiver, but with the appointment coming by stipulation. It seems unlikely, however, that the utility would have agreed to the appointment unless the court was likely to grant it. On the facts presented, the utility had failed to comply with a court order, and its inability (or unwillingness) to post the bond supported the Attorney General's assertions about the company's lack of financial resources. The renewed application thus implicated potential insolvency, evidenced by the inability to pay a debt (i.e., the bond) when due, which is a factor that generally supports the appointment of a receiver. It also involved the failure to comply with a court order, where the Delaware General Corporation Law now codifies the availability of a receiver as a remedy.²⁵

B. *Ellis v. Penn Beef Co.*²⁶

Later in 1911, the Court of Chancery issued what appears to be the second decision appointing a litigation receiver. This time, however, the application was granted over the defendants' opposition.

The *Ellis* case involved a dispute over the ownership of a Penn Beef Company, a Delaware corporation formed to sell meat on commission. Ashworth and Kramer formed Penn Beef and issued themselves shares of stock in return for a refrigerator, certain appliances, and office furniture that they valued at \$20,000. They then issued shares to a third stockholder, Ellis, in exchange for \$20,000 in cash. Ellis became president of the corporation based on a commitment that Ashworth and Kramer would finish furnishing the meat plant at their expense. Ashworth and Kramer failed to fulfill their commitment, resulting in Ellis investing another \$4,800 in the company, and the company paying for the furnishings.

The business was unprofitable, and disputes arose between Ashworth and Kramer, on the one hand, and Ellis on the other. Ashworth and Kramer terminated Ellis as president, and Ellis responded by filing suit against Ashworth and Kramer to cancel their shares for lack of consideration.

Ellis also sought to have a litigation receiver appointed to oversee the affairs of the company pending the outcome of the litigation. The court received evidence from the parties in the form of affidavits, and the record indicated that Ashworth and Kramer had engaged in fraud. The court noted that the property that Ashworth and Kramer claimed to have contributed could not have been worth more than \$8,000, that there was no evidence that they had paid anything for it, and that they had not provided any other consideration for their shares.

The court granted the application for a litigation receiver given "the deep-seated dissensions" between the parties "which are or are likely to be injurious to the continuance of the business of the company, and the ... disproportion of the material interests of ... Ellis, on one side and of Ashworth and Kramer on the other."²⁷ At the time, the Delaware Constitution required that a corporation receive consideration for the issuance of shares, so Ellis's suit for cancellation was

24. *Id.* at 742 ("The Newark Water & Electric Company failed to file the bond within the time specified and upon motion of the solicitors for the complainants, the solicitor for the Newark Water & Electric Company assenting thereto, a receiver pendente lite was appointed on May 1, 1911.").

25. 8 DEL. C. § 322 (2021).

26. 80 A. 666 (Del. Ch. 1911).

27. *Id.* at 669.

quite strong.²⁸ In addition, the failure to appoint a receiver would leave Ashworth and Kramer in charge of the corporation, and they had not previously managed it. The court took these factors into account, observing that Ashworth and Kramer's continued operation of the company could be harmful, that they appeared to be unable to satisfy a judgment, and that they might not even be stockholders. The court also noted that any loss resulting from the receivership would fall entirely on Ellis, because he was the only individual who had contributed capital to the business.

The court directed the receiver "to take charge of and administer the assets, effects, business and affairs of . . . said Penn Beef Company, during the pendency of [the] suit and until a final decree shall have been entered in the same."²⁹ The court stressed that it had not made any final determinations, only granted temporary relief pending the ultimate decision on the merits of the case regarding Ashworth and Kramer's share of corporate ownership.³⁰

The *Ellis* decision stands as the first reported case in which the court appointed a litigation receiver in a contested application. The decision exhibits several features that contributed to the successful application: it was a control dispute where the party seeking a receiver appeared to have a very strong claim, the preliminary record suggested fraud, and the individuals who would run the corporation pending the outcome of the litigation in the absence of a receiver seemed both likely to cause harm and unable to satisfy a judgment.

*C. Frantz v. Templeman Oil Corp.*³¹

It is not until 1926, a decade and a half later, that the reported decisions of the Court of Chancery next reflect the appointment of a litigation receiver. The plaintiffs were stockholders of Templeman Oil Corporation, a controlled subsidiary of the Producers' and Refiners' Corporation. The plaintiffs alleged that F.E. Kistler, the president of Producers, owed Templeman money, but that the Templeman board was not pursuing the claim. The plaintiffs further asserted that a litigation receiver was needed because the statute of limitations on the claim was about to expire.

The Court of Chancery granted the application. The court observed that Templeman was itself a holding company, so the receiver would "not in any manner interfere with the operations of an active producing or manufacturing enterprise."³² The court observed that because of this fact, it would "act with less reluctance in the exercise of the extraordinary relief asked for than it would were the proposition one to take from the chosen and presumably skilled managers of a rather technical enterprise the management and control and place it in the hands of an outsider with possibly less experience in the business and less aptitude for its management."³³

28. DEL. CONST. art. 9, § 3 (repealed 2004) ("No corporation shall issue stock, except for money paid, labor done or personal property, or real estate or leases thereof actually acquired by such corporation."). In 2004, the constitutional requirement cited by the *Ellis* court was repealed and the Delaware General Corporation Law was amended shortly thereafter to provide additional flexibility with respect to forms of consideration that can support a stock issuance. See 8 DEL. C. § 152 (2021).

29. *Penn Beef Co.*, 80 A. at 671.

30. *Id.* at 670.

31. 134 A. 100 (Del. Ch. 1926).

32. *Id.* at 101.

33. *Id.*

The court also cited “more important considerations,” including evidence of fraud.³⁴ The court explained that when the plaintiffs had invested in Templeman, Kistler had agreed to contribute certain leases to Templeman, which he instead held through Producers. The dispute over the leases had arisen six years before, and there was a risk that Producers would attempt to invoke the doctrine of laches. The court also noted that it would be dangerous not to appoint a receiver, because Kistler and Producers had attempted to use their control over Templeman to prejudice the plaintiffs’ claims, including by attempting to have Templeman’s operating subsidiary adjudicated as bankrupt and by allowing Templeman’s charter to become void for nonpayment of taxes.

Given these facts, the court found that an impartial receiver should be “placed in charge of the [the company’s] affairs with the view of protecting its rights and the rights of its stockholders and creditors before time [had] worked to their prejudice.”³⁵ As in the *Ellis* case, the court noted that it was making an interim ruling, such that its description of the facts was “based on the evidence now before me at this interlocutory stage, and is subject to be overcome on final hearing.”³⁶

Like *Ellis*, the *Templeman* case exhibits several features that contributed to the successful application. The plaintiffs appeared to have a very strong claim, and the preliminary record suggested fraud. The facts also suggested that without a receiver, the parties in control of the company would seek to harm it.

D. *Satterthwaite v. Eastern Bankers’ Corp.*³⁷

Six years after the *Templeman* case, in 1931, the Delaware Attorney General sought to have a litigation receiver appointed for Eastern Bankers’ Corporation. Unlike in previous cases, the Attorney General sought a liquidating receiver for the company as a form of final relief. According to the Attorney General, the managers of the company had falsified its books and claimed fictitious profits, then declared significant dividends based on the false profits. The Attorney General sought to prove the fraud, revoke the corporation’s charter, and have a receiver wind up its affairs.

The application for an interim receiver became necessary because the corporation had paid income taxes to the United States based on its fictitious profits. The Attorney General wanted a receiver to apply for a tax refund before an upcoming deadline for making that claim. If the deadline passed, then the value of the claim would be lost.

The Court of Chancery granted the application for a litigation receiver. The court reasoned that the corporation was entitled to have its claim for a refund presented and that the corporation’s management could not be relied upon to seek the refund because doing so ran contrary to their interests in defending against the charges of fraud.

Like the *Gray* case, *Satterthwaite* involved an application by the Attorney General. Its facts, however, resembled a blend of the *Ellis* and *Templeman* decisions. As in both of those precedents, the case involved allegations of fraud, and as in the *Templeman* case, the *Satterthwaite* decision involved a timeliness issue that a receiver could solve.

E. *Morford ex rel. Gray v. Trustees of Middletown Academy*³⁸

In 1940, the Delaware Attorney General sought the appointment of a litigation receiver in a third case. This time the dispute involved the Middletown Academy, a charitable corporation which had operated a school from 1827 until 1929

34. *Id.*

35. *Id.* at 102.

36. *Id.*

37. 154 A. 475 (Del. Ch. 1931).

38. 14 A.2d 382 (Del. Ch. 1940).

and which continued to own a tract of land and the former school building. In 1939, a majority of the trustees voted to sell the bulk of the land to the United States to use as a post office. Before the transaction closed, the Attorney General challenged the conveyance, contending that the purpose of the corporation was to operate a school and the transfer of the land ran contrary to and would prevent the corporation from fulfilling its purpose. As final relief, the Attorney General sought to have the corporation's charter revoked and, if necessary, to recover damages for the unlawful sale.

The Attorney General sought the appointment of a litigation receiver as interim relief after learning from the minority trustees that the majority wanted to consummate the sale. The purpose of the litigation receiver was to protect the corporation's interests, initially by not completing the sale and, if necessary, by asserting a claim for damages. The corporation opposed the application on the grounds that the United States already had equitable title and the right to possess of the land.

The court agreed with the Attorney General and appointed a litigation receiver "to preserve the present situation so that the land disposed of [would] not be put beyond recall, or, if this [was] impossible, to obtain the full measure of compensation for the land."³⁹

The court seemingly viewed the Attorney General as having a strong case, noting:

The corporate purpose of defendant is the establishment and operation of an academy in Middletown as a seminary of useful learning. Aside from bald assertions to the contrary by the majority trustees, I find nothing in the record to show how the disposal of the lot to the United States could do anything but prevent the use of the academy building and remaining property to carry out the corporate purpose.⁴⁰

The court also expressed concern about the consideration that the corporation was receiving in the sale, noting that the United States initially offered \$8,000, but that the final offer was for \$5,000 and that a portion of that amount would go to the City of Middletown.⁴¹ The court noted that the corporation might have a claim for damages and that the trustees might face liability if the corporation received inadequate consideration. Because of their potential liability, the trustees could not be expected to make an impartial decision regarding the corporation's litigation asset and an impartial receiver was necessary to evaluate it.⁴² Finally, the court noted that the corporation had been generally inactive for the past ten years, such that "there should be less reluctance to appoint a [litigation receiver] than in the case of an active producing or manufacturing enterprise."⁴³

The *Morford* case differs from earlier decisions in that it lacks the strong sense of fraud present in the *Ellis*, *Templeman*, and *Satterthwaite* cases. The court also seems to have questioned whether a litigation receiver could maintain the status quo, observing that the receiver "could not, of course, prevent the United States from taking immediate possession of the land ..."⁴⁴ In addition, compared to *Templeman* and *Satterthwaite*, the court's discussion of the need for a receiver

39. *Id.* at 386.

40. *Id.* at 383.

41. *Id.* at 385.

42. *Id.*

43. *Id.*

44. *Id.*

to address the litigation asset also seems less compelling, because there does not appear to have been any time pressure on the assertion of the claim. Instead, the language of the decision suggests that the court believed a receiver might be able to help broker a settlement that would resolve a difficult situation.

F. *Vredenburg v. Jones*⁴⁵

After the *Morford* case, the Court of Chancery does not appear to have issued a ruling appointing a litigation receiver until 1975.⁴⁶ The thirty-five-year drought came to an end in the *Vredenburg* case, where the plaintiffs sought to have a litigation receiver appointed for Arundel Mining Co., Inc. to stop a pending sale of substantially all of the company's assets, including its mining lease and all of its on-site equipment. On the same day that the court heard argument on the application, the defendants completed the sale. They notified the court the following day that the transaction had closed.

Even though the litigation receiver could no longer stop the pending transaction, the court granted the application. The court gave only a relatively cursory explanation, stating that "the circumstances seem to dictate that a receiver should be appointed to investigate the situation, take charge of the corporate assets and report to the court pending the outcome of the present litigation."⁴⁷ The court noted that as a result of the sale, the company likely possessed only cash and a stock portfolio that had not been sold. Although the court did not say so explicitly, that state of affairs meant that the court was not appointing a litigation receiver for an operating concern. Rather, as in the *Templeman*, *Satterthwaite*, and *Morford* cases, the court was appointing a litigation receiver for a non-operating entity.

There is also a sense from the decision that the court had concerns about how the defendants had chosen to proceed. The court did not seem pleased to have been "advised that the closing of this transaction in fact took place yesterday afternoon at or about the same time the Court was being asked to appoint a receiver to look into this proposed sale of assets."⁴⁸ The court also noted that "those presently in control of the corporation as officers and directors are defendants in this litigation, some of whom refused to submit themselves to jurisdiction in this State."⁴⁹ The defendants who contested jurisdiction took the position that they did not have to respond to the court's orders.

The solution to these problems was to appoint a litigation receiver in whom the court had confidence. The court chose to appoint Andrew G.T. Moore, II, the future Delaware Supreme Court justice, who was then serving as Delaware counsel for Arundel Mining Co. The court cited Moore's "existing knowledge of matters, with all their attendant complications, and the commendable service and professional courtesy he has extended to the corporation, the court and other counsel throughout."⁵⁰ It seems likely that the court believed that Moore would be able to get to the bottom of what had happened.

45. 1975 WL 1264 (Del. Ch. Oct. 3, 1975).

46. It is possible that the court appointed a receiver in a ruling that is no longer readily accessible, such as in an order or a transcript ruling, but research has not revealed it.

47. *Vredenburg*, 1975 WL 1264, at *1.

48. *Id.*

49. *Id.*

50. *Id.*

The *Vredenburg* case stands with the *Morford* case as an idiosyncratic situation for the appointment of a litigation receiver. As in *Morford*, the case lacks a strong suggestion of fraud, and the closing of the transaction prevented the litigation receiver from preserving the status quo as originally intended. The court nevertheless appointed the receiver anyway, seemingly in an effort to examine why the transaction had closed while a hearing on interim relief was ongoing.

G. *Jagodzinski v. Silicon Valley Innovation Co., LLC*⁵¹

After the *Vredenburg* decision, there was another multi-decade drought before the Court of Chancery again granted an application for a litigation receiver.⁵² The concept of a litigation receiver resurfaced visibly in 2012 in a decision involving Silicon Valley Innovation Co., LLC, a Delaware limited liability company. The plaintiff, a member of the LLC, sought books and records under Section 18-305 of the Delaware Limited Liability Company Act, and the court had issued several orders requiring the company to produce the relevant documents and obtain Delaware counsel. The company did not produce all of the documents or obtain Delaware counsel, and the plaintiff moved to hold the company in contempt. As a remedy, the member sought a receiver with the broad authority to conduct the company's business and pursue any claims belonging to the company.

The court agreed that the company was in contempt and also agreed that a receiver was appropriate, but the court did not appoint the broadly empowered receiver that the unit holder sought. Instead, the court appointed a litigation receiver for the limited purpose of curing the contempt by causing the company to produce the required documents. The court granted that the receiver "may collect, review, and produce documents in Defendant's files and storage facilities[,] . . . [and] attempt to obtain the documents at issue from third parties where [the company] reasonably can claim to have control over such documents."⁵³ The receiver would be discharged after collecting and producing the documents required.

After being appointed, the receiver diligently found or recreated, as necessary, the documents that the court ordered to be produced. In doing so, the receiver discovered evidence of widespread self-dealing and looting at the company. The court therefore elevated the receiver to the status of a "full-blown receiver" with the power to manage the company and protect its assets.⁵⁴ The court also changed the receiver's compensation structure from an hourly rate to a monthly fee plus a contingent bonus equal to 10% of amounts recovered by the company.⁵⁵

Over the next two years, the receiver filed sixteen lawsuits against former managers and advisors to the company. In the most significant case, the receiver asserted claims that could entitle the company to recover over \$100 million.

Ironically, the plaintiff who originally sought the appointment of the receiver petitioned to have the court terminate the receivership and allow the plaintiff to pursue the litigation. Alternatively, the plaintiff asked the court to modify the receiver's compensation so that he would not potentially receive a \$10 million fee.

The court denied the plaintiff's petition to terminate the receivership, finding that the purpose of the receivership had not yet been fulfilled. The court concluded that the receiver remained the best person to oversee the litigation

51. 2012 WL 593613 (Del. Ch. Feb. 14, 2012).

52. It is again possible that an order or transcript ruling granted that relief, but research has not revealed it.

53. *Jagodzinski*, 2012 WL 593613, at *3.

54. *Jagodzinski v. Silicon Valley Innovation Co.*, 2015 WL 4694095, at *2 (Del. Ch. Aug. 7, 2015).

55. *Id.*

because (1) the current receiver had the greatest institutional knowledge of the company and lawsuits, (2) the plaintiff was the party who originally requested that particular individual to serve as receiver, (3) the plaintiff had shown little respect for the court's orders and tried to act as though he was the receiver, which was a "brazen affront" to the court, and (4) the court was concerned that ending the receivership would deprive the company of the benefits of the receivership, and likely would place the company at risk for bankruptcy.⁵⁶ The court did, however, modify the receiver's compensation structure to make clear that the receiver would receive 10% of any net recovery, after the payment of all expenses.⁵⁷

The *Jagodzinski* case marks what appears to be the first use of a litigation receiver to enforce an order in a books and records case. In doing so, the court followed the well-established path of appointing a receiver to enforce a court order, traceable initially to the *Gray* case.⁵⁸

H. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*⁵⁹

In 2019, the Court of Chancery appointed a litigation receiver in what is presently the most recent example of the court's exercise of that authority. The case involved a failing business, risk of harm to vulnerable people, and a defendant who appeared to be playing games with the court.

The Delaware entities at issue in the case were part of a complicated web of companies that operated senior living facilities. The plaintiffs were minority investors in the entities. An individual named Andrew White controlled the entities.

The plaintiffs filed suit in Delaware asserting claims for breach of fiduciary duty and breach of contract. They also filed a motion seeking the appointment of a litigation receiver. Prior to the hearing on that motion, the court entered an interim status quo order.

As the court pithily described the situation, the entities were "in trouble."⁶⁰ They faced litigation in multiple jurisdictions, including proceedings initiated by state regulators. Moreover, because of the nature of the business, there were broader concerns in play:

The nature of this business is nursing care, and as a result, negligent or incompetent leadership affects vulnerable people, whose lives are affected by these [entities'] fates; residents at the nursing homes, whose health, care, and wellbeing depend on the [entities'] proper management. Though yet unproven in this case, there are allegations that the delivery of food for the residents has been interrupted. There is evidence that residents' rent checks have gone uncashed, leaving them to question whether their housing is assured. There is evidence that residents have been "evacuated" from certain facilities. There is evidence that employees who provide direct

56. *Id.* at *11.

57. *Id.*

58. *See, e.g.,* *Deutsch v. ZST Digit. Networks, Inc.*, 2018 WL 3005822, at *4 (Del. Ch. June 14, 2018) (describing earlier order appointing receiver as contempt sanction); *Williams v. Calypso Wireless, Inc.*, 2012 WL 424880, at *1 (Del. Ch. Feb. 8, 2012) (appointing receiver to address corporation's "protracted failure to comply with an order of this Court").

59. 2019 WL 1501553 (Del. Ch. Apr. 4, 2019). The receiver in this case was represented by Wilson Sonsini Goodrich & Rosati. The opinions expressed in this article are the authors' own and do not represent the views of the receiver or Wilson Sonsini Goodrich & Rosati.

60. *Id.* at *1.

care to residents have, on multiple occasions, not been paid on time—sometimes days or even weeks late. I note this not to suggest that cases involving other business entities lack importance, nor that they cannot also be disruptive of human lives—they can be, and often are. What I do mean to suggest is that the exigencies of this particular business compel especially focused attention.⁶¹

The nature of the business thus made the potential need for a litigation receiver more compelling.

The court also had reason to question White's actions. The court noted that on the evening before an evidentiary hearing on the application for a litigation receiver, the defendants' counsel informed the court that White could not attend the hearing and would not be able to testify. The court dryly commented on this development:

Given that the hearing had already been rescheduled (by my count, at least three times, and on at least one occasion due to Mr. White's schedule and preferences), and given that Mr. White's counsel was present and ready to proceed, I informed the parties that the evidentiary hearing would commence without Mr. White.⁶²

At the conclusion of the hearing, based on the record presented, the court appointed former Chancellor William B. Chandler III as an interim receiver. The court specifically ordered White to cooperate with the receiver. The court also held that as soon as White could travel and testify, the court would hold a further hearing to consider the appointment.

White did not cooperate with the receiver.⁶³ He delayed transferring control over the entities and their assets, and he failed to provide information when requested.⁶⁴ Eventually, White's lack of responsiveness caused the receiver to request leave to withdraw.⁶⁵ The court granted the application and appointed an entity associated with the plaintiffs as a replacement receiver.⁶⁶ The court held White in contempt, ordered him to pay the plaintiff's attorneys' fees and expenses for a hearing White failed to attend, and ordered White to pay the receiver's fees and expenses that were incurred as a result of his uncooperative behavior.⁶⁷

The *GMF* decision stands as a unique case that combines the threats present in prior litigation receiver decisions. It begins with the element of a failing enterprise, where a receiver may be warranted, then adds the special dimension of senior living centers involving vulnerable individuals. As in the *Vredenburg* case, where the court appointed a litigation receiver after the defendants closed a transaction on the same day that the court was holding a hearing, the court in *GMF*

61. *Id.* at *2.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC, C.A. No. 2018-0840-SG, Order* (Del. Ch. Apr. 5, 2019).

67. *GMF*, 2019 WL 1501553, at *5.

seems to have been influenced in part by White's seemingly disingenuous efforts to avoid a hearing in Delaware. Eventually, the case involved a lack of cooperation that resulted in contempt.

III. REPRESENTATIVE CASES DENYING APPLICATIONS FOR THE APPOINTMENT OF A LITIGATION RECEIVER

The preceding section discussed the few cases in which Delaware courts have appointed litigation receivers. Given the extraordinary nature of the remedy, there are far more cases denying petitions to appoint litigation receivers. To chronicle all of them in detail would be unhelpful. Modern decisions denying requests for the appointment of a litigation receiver have largely dispensed with the more instructive discussions that often characterized the Court of Chancery's earlier decisions. Even in the absence of such detail, however, these cases continue to demonstrate the hesitancy of the court to appoint a litigation receiver in all but the clearest of cases. Moreover, these recent cases provide some additional context for situations in which a litigation receiver is inappropriate.

A. *TVI Corp. v. Gallagher*⁶⁸

In 2013, the Court of Chancery declined to appoint a litigation receiver in *TVI Corp. v. Gallagher*.⁶⁹ This case involved iCueTV, Inc., a closely-held corporation founded by Gallagher, Huegel and Singley, which had patented a system that allowed television viewers to interact with program content. The company was primarily owned by the plaintiffs and their families and friends, and in exchange for their investments, Thompson, Katcher, Khichadia, and Harrington all were given board seats. The founders also were members of the board.⁷⁰

Despite marketing its interactive technology over several years, the company did not generate significant revenue and was churning through its cash reserves, such that one of the founders notified the stockholders that without substantial capital infusions from its investors, the company would not have the funds to continue its operations.

Regardless, however, of the company's financial troubles, Huegel caused the company to enter into a lucrative employment contract with its CEO, Gates. Gallagher, as iCueTV's Chairman, entered into similarly lucrative employment agreements on behalf of the company with Huegel and Singley. The company's board did not have prior notice of, or approve, any of these agreements. Plaintiffs alleged that collectively, these agreements created \$7 million in liabilities for the company and "carried interests" of shares of iCueTV stock provided to Huegel and Singley under the employment agreements enabled the founders to obtain greater voting control over company.

Thompson, a director of the company and the Chair of the Audit Committee, discovered these agreements. He complained that they were not approved by the board and requested an outside audit of the company's financial records. Gallagher, Huegel, and Singley thereafter organized a board meeting and but did not give notice of the meeting to Thompson. At the meeting, the board purported to remove Thompson as a director. Another board meeting was then held approving the Huegel and Singley employment agreements, but the Gates agreement was never approved.

68. 2013 WL 5809271 (Del. Ch. Oct. 28, 2013).

69. *Id.*

70. The number of authorized directorships and full composition of the board are not included in the recitation of facts.

Thompson later brought a Section 220 demand, and subsequently, non-founder directors Katcher, Khichadia, and Harrington requested the formation of a committee to investigate allegations of waste and misappropriation of the company's assets. Gallagher quickly called a special meeting of stockholders at which Katcher, Khichadia, and Harrington were removed as directors. Even though Katcher, Khichadia, and Harrington were stockholders, they were not provided with notice of the purpose of this meeting. At that meeting, a committee composed of two non-founder directors was appointed to investigate wrongdoing and the committee requested that a third party be retained to conduct a full investigation, but Gallagher determined (without inquiry) that there was no merit to the allegations and ended the investigation.

In addition to these corporate governance issues, Gallagher had also provided unspecified funding to the company, which the board did not approve in the first instance. The board later retroactively approved the funding and provided Gallagher with a convertible note that permitted him to choose, at the time of repayment, how his funding would be treated. If he chose to have his advances treated as debt, he would be entitled to be repaid in full with interest before payment to any of the other investors.

Among other things, the plaintiffs challenged the employment agreements and preferential terms of Gallagher's funding and, in August 2012, brought a derivative suit, which included a claim for breach of fiduciary duties and waste, a claim for declaratory and injunctive relief, and a claim for the appointment of a custodian or a litigation receiver to: "(1) direct and supervise iCueTV's business and affairs pending a decision on the merits of Plaintiffs' claims; (2) sell off for fair value the Company's assets; and (3) distribute the proceeds from that sale in accordance with the creditors' and shareholders' interests as determined by the Court."⁷¹ By October 2012, Gallagher had stopped providing funding to the company, and the company defaulted on its lease, was unable to make payroll, had its internet servers shut off, and could not fulfill various other obligations. It was within this context that the plaintiffs further alleged that Gallagher, Huegel, and Singley were trying to sell or divest the company's assets for less than fair value with the intention of keeping the proceeds for themselves, purportedly as repayment of their employment compensation and Gallagher's prior loans to the company. The court granted a stipulated status quo order prohibiting defendants from selling any of the company's principal assets, repaying Huegel or Singley compensation under the employment agreements, or repaying any amounts that the defendants had loaned to the company without first providing twenty days written notice to plaintiffs.

The court was clearly concerned about the actions that had taken place, which is evidenced by its holding that demand futility had been established by the facts of the case and the court's denial of the defendants' motion to dismiss the duty of loyalty claims. The court noted that if the plaintiffs prevailed on their fiduciary duty claims, it was feasible that the court would appoint a receiver at that time, but that the plaintiffs did not show that appointment of a litigation receiver was necessary prior to a decision on the merits of the case. The court's reasoning was that the status quo order created a 20-day window during which the plaintiffs could challenge any specific transaction that defendants intended to consummate.⁷² This outcome can be contrasted against the *GMF* litigation, where the court appointed a litigation receiver despite there being a status quo order in place. The result in *TVI Corp.* shows that the court will rely on the other, less extreme, equitable tools at its disposal prior to appointing a litigation receiver. That said, *GMF* serves as a reminder that in egregious situations, a status quo order alone may not provide enough protection.

71. *TVI Corp. v. Gallagher*, 2013 WL 5809271, at *19 (Del. Ch. Oct. 28, 2013).

72. *Id.*

B. *Beal Bank, SSB v. Lucks*⁷³

The second representative case provides a more fulsome discussion of the specific facts that could lead a court to deny an application for the appointment of a litigation receiver. This 1998 decision involved a request by a bank for the appointment of a litigation receiver during the pendency of a dispute over the right to collect rent from a tenant. The bank claimed that the developer of commercial real estate granted the bank assignment of its right to collect rent from tenants and that the bank provided financing to the developer based in part on the assignment. The developer then sold the property to a new owner, which claimed it had been sold free and clear of any encumbrances. After the developer declared bankruptcy, the bank sought to recover on the assignment of rent, and the new owner disputed the bank's claim.

The bank sought a litigation receiver to collect and hold the rents. The bank contended that the new owner was a shell entity that would disburse any rents it collected and declare bankruptcy as soon as the bank obtained a judgment. The defendants countered that the bank could not demonstrate a sufficient right to collect the rents in question. The bank conceded that it was not concerned about the day-to-day upkeep of the property itself, which was managed by a responsible tenant.

The court framed the inquiry as whether the bank had shown a threat of imminent irreparable injury and the need for a litigation receiver that could prevent that loss. The court found that the claimed harm was insufficient, noting that it merely represented a "common place business risk that one may not be paid that to which one is entitled before a debtor declares insolvency."⁷⁴

The court also found that the facts of the case were insufficiently clear to support the appointment of a litigation receiver. The court regarded the record as presenting a "tangled web of factual confusion [that] hardly meets even a minimum threshold of clarity."⁷⁵ Rather than presenting a clear case, the bank had offered "only a possibility that [it] may not be ultimately paid and may accordingly suffer a monetary loss"⁷⁶ The case also involved a situation where only money was at issue; neither the property nor the tenancy was threatened.⁷⁷

IV. LESSONS FROM THE CASE LAW

The cases involving the appointment of litigation receivers are largely fact-specific. There are few cases in which the court has appointed litigation receivers, and many where it has not. Because the cases are so fact dependent, it is difficult to find consistent principles. It nevertheless remains possible to make some observations.

First, a party seeking a litigation receiver needs a strong claim, grounded on compelling facts. As suggested by the references in the decisions to fraud or gross mismanagement, the court's equitable heartstrings will most likely respond to situations that appear to involve egregious misconduct, such as the fraud in the initial *Ellis* case.

Second, a party seeking a litigation receiver will need to point to a threat of irreparable harm that cannot be addressed through other forms of interim relief. In the early decisions, parties seem to have used a request for a litigation

73. 1998 WL 778362 (Del. Ch. Oct. 23, 1998).

74. *Id.* at *3.

75. *Id.*

76. *Id.*

77. *Id.*

receiver as a means of maintaining the status quo. Under current Chancery practice, it is customary for the court to address situations involving threats of interim harm through the use of a status quo order or other form of injunction. To obtain a litigation receiver, a party would need to show why a status quo order would be inadequate. The cases suggest that to make such a showing, the petitioner must convince the court that the defendant is a bad actor who cannot be trusted.

Third and more broadly, the court approaches a request to appoint a litigation receiver with the practical considerations of running a business in mind. For example, the cases indicate that the court will be more willing to appoint a litigation receiver for a holding company or other simple entity structure than for an operating enterprise with complicated and ongoing business.⁷⁸ At the same time, the court will take into account the nature of the business and the risk of harm to others. The *GMF* decision involving senior care facilities demonstrates that the court will more readily appoint a receiver to ensure that a company in charge of others' wellbeing continues to operate than to simply ensure that a bank receives rent payments it is due.⁷⁹

Fourth, the conduct of the parties and their credibility seems to play a role. It is noteworthy how many of the successful applications for litigation receivers have involved the Delaware Attorney General. It is perhaps unsurprising, however, that the court would give credit to applications by an elected official charged with protecting Delaware's citizens.⁸⁰ At the other extreme, parties who appear to be playing games with the court seem to have given the court a push towards the appointment of a litigation receiver. In the *Vredenburgh* case, the parties closed the challenged transaction on the same day that the hearing on the appointment of a litigation receiver was taking place, which seems to have troubled the court. Similarly, in the *GMF* case, the principal defendant forced the court to reschedule the hearing on a litigation receiver on three occasions, then announced on the day before the scheduled hearing that he would not attend. The court proceeded with the hearing and appointed a litigation receiver.

Finally, perhaps the easiest way for a party to trigger the appointment of a litigation receiver is to fail to comply with a court order, resulting in a finding of contempt. Both as a matter of statute and under the common law, the Court of Chancery can appoint a litigation receiver to enforce its orders. The cases demonstrate that the court is willing to take this step.⁸¹

Taken together, the Court of Chancery's approach to requests for litigation receivers has been thoughtful and holistic. Just as Spiderman would not use his superhuman strength to move a car simply because the parking meter had expired, the Court of Chancery will not deploy the extraordinary remedy of a litigation receiver for typical corporate disputes. Instead, the court uses its equitable Spidey-sense⁸² to consider the conduct at issue and its real-world implications.

78. See *Frantz v. Templeman Oil Corp.*, 134 A. 100 (Del. Ch. 1926).

79. Compare *Beal Bank, SSB v. Lucks*, 1998 WL 778362 (Del. Ch. Oct. 23, 1998) with *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*, 2019 WL 1501553 (Del. Ch. Apr. 4, 2019).

80. See *Gray v. Council of Newark*, 79 A. 739 (Del. Ch. 1911); *Morford ex rel. Gray v. Trustees of Middletown Academy*, 14 A.2d 382 (Del. Ch. 1940); *Satterthwaite v. Eastern Bankers' Corp.*, 154 A. 475 (Del. Ch. 1931).

81. See, e.g., *Gray*, 79 A. 739; *Jagodzinski v. Silicon Valley Innovation Co.*, 2015 WL 4694095 (Del. Ch. Aug. 7, 2015); *GMF*, 2019 WL 1501553.

82. The authors propose that this remarkable ability, which the Court of Chancery has demonstrated throughout its existence, henceforth be referred to as "equi-sense."

V. THE NUTS AND BOLTS OF LITIGATION RECEIVERS

Obtaining a ruling appointing a litigation receiver is only the first step. The parties must also assist the court in crafting the details of the receivership.

The Court of Chancery Rules that govern all receiverships—Rules 148 through 168—do not provide much guidance for a litigation receivership.⁸³ Many of these rules envision a receiver that takes charge of a liquidation, which is typically not the role of a litigation receiver. There are also reporting and financial requirements that generally do not make sense for litigation receivers.

Because the scope of a litigation receivership is specifically tailored to the particular facts of each individual case, the Court of Chancery often will not require adherence to the default rules. Chancery Rule 148 provides that “the court may relieve the receivers or trustees from complying with all or any of the duties and procedures set forth in Rules 149 through 168 and may impose such other duties or prescribe such other procedures as the court may deem appropriate.”⁸⁴ The order appointing a litigation receiver will trump the default rules.

The contents of an order appointing a litigation receiver will vary from case to case. The following is a brief discussion of the topics that the order will usually address as well as sample language drawn from the Court of Chancery’s order appointing a litigation receiver in the *GMF* action.

A. Scope of Authority

A litigation receiver is an agent of the Court of Chancery, and the receiver’s power and authority are limited to what is set forth in the appointment order.⁸⁵ In fashioning the order, the Court of Chancery will consider “the character of the business and property of the corporation, and the object to be accomplished” by the receivership.⁸⁶ Because the Court of Chancery can (and does) tailor the receivership to the particular needs in a specific case, the power and authority granted to receivers will vary. In some instances, the court has granted full power and authority to the litigation receiver to run the corporation’s business, protect or dispose of its assets, oversee litigation, and the like.⁸⁷ In other cases, the court has granted more limited authority, such as only the power to respond to books and records requests⁸⁸ or to preserve the status quo with respect to a sale of specific assets.⁸⁹

83. Rules of the Delaware State Courts, Court of Chancery Rules 148-168 (2021).

84. Court of Chancery Rule 148.

85. *Clark v. State*, 269 A.2d 59, 61-62 (Del. 1970) (noting some differences between receivers appointed for corporations pursuant to provisions of the Delaware General Corporation Law and other receivers appointed “pursuant to the general powers of the Court of Chancery” to conserve debtor’s assets for later payment of creditors, including that statutory receivers obtain by operation of law title to corporate assets and records, while other receivers enjoy only power specified in order appointing them).

86. *Ellis v. Penn Beef Co.*, 80 A. 666, 670 (Del. Ch. 1911).

87. *See, e.g., Jagodzinski*, 2015 WL 4694095, at *2.

88. *Jagodzinski v. Silicon Valley Innovation Co.*, 2012 WL 593613, at *3 (Del. Ch. Feb. 14, 2012).

89. *Morford ex rel. Gray v. Trustees of Middletown Academy*, 14 A.2d 382, 386 (Del. Ch. 1940).

As the case law makes clear, what may appear to be a relatively straightforward task for the litigation receiver at the outset can turn into something far more complex than expected. This can be due to members of management failing to cooperate with (or actively hindering) the work of the receiver, or the uncovering of additional issues as the receiver peels back the proverbial layers of the onion.⁹⁰ In such a case, the receiver can file a motion to modify the order.⁹¹

An example of the language a receivership order may contain can be found in *GMF*. As noted above, the receiver in that case was granted broad authority, including the power to make an evaluation concerning the continued need for a litigation receiver and report back to the court:

The Receiver shall have all power, authority and discretion to [marshal and preserve assets and operate the business]. In furtherance of the foregoing, the Receiver shall: (a) direct the operation of the business ... in accordance with the terms of each entity's governing documents, (b) marshal the assets of the Companies by identifying available funds and discharging debts of the Companies, and (c) take any and all actions necessary to preserve the value of the assets of the Companies. In addition to the foregoing, promptly following appointment, the Receiver shall evaluate whether a continuing receivership *pendente lite* is necessary ... and shall report his findings on these issues to the Court....⁹²

B. Ability to Hire Advisors

Depending on the breadth of the receiver's power and authority, it may be advisable for the receiver to engage advisors. For example, if a receiver is charged with complete power and authority with respect to the company, the receiver may wish to engage an accountant to help review the company's financial statements and other records to determine if there are any issues to be addressed and to put the books and records in order, handle tax issues, and otherwise provide guidance on the money side of the business.⁹³ Similarly, if the company is involved in litigation or corporate transactions, the receiver may wish to hire legal counsel.⁹⁴ The Court of Chancery can grant the receiver the power and authority to hire advisors in the initial order, or, if it was not included in the initial order, the receiver can seek a modified order from the court allowing the receiver to engage advisors. The order in *GMF* contained the following language relating to the retention of advisors:

For the avoidance of doubt, the Interim Receiver may retain such counsel to advise it with respect to its duties under this Order as it deems appropriate. The fees of counsel so retained shall be calculated on the same hourly rate charged by such counsel to clients represented outside of this matter and as the expenses shall be calculated

90. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*, 2019 WL 1501553, at *2 (Del. Ch. Apr. 4, 2019); *Jagodzinski*, 2015 WL 4694095, at *2.

91. *GMF*, 2019 WL 1501553, at *2; *Jagodzinski*, 2015 WL 4694095, at *2.

92. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*, C.A. No. 2018-0840-SG, Order (Del. Ch. Feb. 7, 2019).

93. *Receivership Practice*, *supra* note 2, at 497.

94. *Id.*

for such other clients. The fees and expenses of such counsel shall be paid by the Companies in accordance with the same procedure established herein for payment of the fees and expenses of the Interim Receiver.⁹⁵

C. Limitation of Liability

As an agent of the court, so long as the receiver acts in accordance with the order, the receiver should be protected from liability.⁹⁶ Even so, as the case law has revealed, receiverships can be contentious (often because potentially recalcitrant managers of the company are being forced to cede their power and authority to the receiver, often in the face of misconduct allegations). Further, operating a business involves multiple layers of applicable laws and regulations beyond general Delaware corporate law (e.g., employment law, etc.), which could lead to potential foot faults for a receiver who is unfamiliar with the particular business and industry. A receiver can request that the appointing court order include broad indemnification and limitation from liability language in the order.

As expected, the *GMF* order provides such language:

The Receiver shall not have any liability to the Companies or any person for acts taken in good faith in accordance with the terms of this Order. None of the parties to this action, nor any other person purporting to act in their capacity as a director, officer, employee, representative, agent, general partner, limited partner, manager, member, managing member, stockholder, equityholder or creditor of the Companies, shall institute any legal proceeding challenging any action or decision by the Receiver in performing his duties hereunder in any forum other than in the Court. The Companies shall jointly and severally indemnify the Receiver and hold him harmless from any liability to the fullest extent permissible by Delaware law and any other applicable law. In addition, at the Receiver's request, the Companies shall procure and maintain for his benefit adequate liability insurance coverage or such other protection from liability as the Receiver may reasonably require. Expenses, including attorneys' fees, incurred by the Receiver in defending any civil, criminal, administrative or investigative action, suit or proceeding shall be paid by the Companies in advance of the final disposition of such action, suit or proceeding, subject only to the repayment of such amount, if any, that it is determined by this Court in a final unappealable order to have been beyond that which could lawfully be paid pursuant to Delaware law or other applicable law. For the avoidance of doubt, the Companies' obligation to reimburse the Receiver for all expenses, including attorneys' fees, as provided in this paragraph or otherwise in this Order, shall be joint and several among the Companies during the time that each such entity is under receivership, and shall extend to and cover expenses, including attorneys' fees, incurred by the Receiver in connection with any action, motion or other proceeding

95. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC, C.A. No. 2018-0840-SG, Order* (Del. Ch. Apr. 15, 2019).

96. *Receivership Practice, supra* note 2, at 491 ("So long as there is full disclosure to the court of all relevant facts, the order authorizing any given act by the trustee or receiver operates as a defense to any claim that the trustee or receiver acted improperly as a fiduciary.").

brought by Defendants, or at their behest, to challenge any act, conduct or decision by the Receiver, unless the Court determines that such act, conduct or decision was taken or made in bad faith.⁹⁷

D. Jurisdiction

Generally speaking, the Court of Chancery will retain jurisdiction to hear applications from the litigation receiver for assistance from the court. Such assistance is often necessary given the extreme fact patterns that characterize most actions involving litigation receivers. For example, in *GMF*, the court's order contained this simple language: "The Court retains jurisdiction over this action to consider any applications that the Receiver may make for the Court's assistance in dealing with any problems encountered by the Receiver in performing his duties hereunder."⁹⁸ The court may—as it does in other receivership contexts—also order that any actions brought against the receiver must first be approved by the Court of Chancery. Such language can be helpful in deterring aggrieved parties from harassing the receiver with frivolous lawsuits. The following is an example of such language from an order appointing a receiver for an insolvent corporation pursuant to 8 Del. C. § 291:

The parties in this case and their respective attorneys, servants, agents, and employees, are, jointly and severally, enjoined and stayed from commencing any action at law or suit or proceeding in equity in any Court or to prosecute any claim against [the Receiver], or any entity in which he holds an interest, or any of his agents, relating to the Receiver's actions with respect to the Corporation, without prior approval of the Court. The Court will undertake a review of the facts and circumstances, and determine whether such action is meritorious or interposed for the purpose of harassment of the Receiver.⁹⁹

E. Fees And Expenses

Another important matter that is typically covered in the order relates to the receiver's fees and expenses, including the issue of who pays the fees and expenses and the amounts of such fees. In *GMF*, the receiver was entitled to be compensated at his standard professional hourly rate and was to be reimbursed for all reasonable, documented, out-of-pocket expenses, including travel expenses and fees associated with retaining any consultants or outside advisors. The court also ordered that the nominal defendants (*i.e.*, the entities that the receiver was overseeing) would be jointly and severally liable for such fees:

The Receiver shall be compensated for his time at his standard hourly rate and shall be promptly reimbursed for all reasonable, documented, out-of-pocket expenses, including, without limitation, travel expenses and outside counsel fees and expenses, as well as the fees and expenses of any consultants and other advisors retained by

97. *GMF ELCM Fund L.P. v. ELCM HCRE GP LLC*, C.A. No. 2018-0840-SG, Order at 6-8 (Del. Ch. Feb. 7, 2019).

98. *Id.* at *8.

99. *Wheeler v. CTPartners Exec. Search Inc.*, C.A. No. 11389-VCL, Order at 11 (Del. Ch. Nov. 12, 2015).

the Receiver (as he determines in good faith to be necessary). For the avoidance of doubt, the Receiver may retain such counsel to advise him with respect to his duties under this Order as he deems appropriate, which counsel may include the law firm of Wilson Sonsini Goodrich & Rosati, P.C. The fees of counsel so retained shall be calculated on the same hourly rate charged by such counsel to clients represented outside of this matter and as the expenses shall be calculated for such other clients. The retention of the services of such counsel, advisor(s) and/or consultant(s) shall not require the prior approval of the Court, provided that the Receiver is satisfied that any fee to be charged is reasonable and in accordance with the terms of this Order. The Companies shall be jointly and severally responsible for all such fees and expenses during the time that each such entity is under receivership.¹⁰⁰

The parties' responsibilities to pay the receivers expenses should include indemnification, advancement, and insurance obligations.¹⁰¹

VI. CONCLUSION

Though it is not often granted, the litigation receivership is alive and well in Delaware. The case law, with its interesting and pugnacious fact patterns, reveals that the Court of Chancery will use this remedy when warranted while also exercising restraint to avoid its abuse. When circumstances call for a litigation receiver, the court will tailor the receivership to the facts of the case to avoid overstepping the bounds of what is necessary to achieve equity. Perhaps the most interesting aspect of the litigation receivership, though, is that the broad scope of available powers and the standards used to evaluate a request for such relief today have remained virtually unchanged for over a century. The fact that no decisions have sought to radically alter this approach serves as a testament to both the utility of this superpower of equity and the court's wisdom in using it sparingly.

100. GMF ELCM Fund L.P. v. ELCM HCRE GP LLC, C.A. No. 2018-0840-SG, Order at 6 (Del. Ch. Feb. 7, 2019).

101. See text accompanying note 97, *supra*.

NATIONAL REAL ESTATE BAR GUIDANCE ON U.C.C. OPINIONS IN COMMERCIAL REAL ESTATE FINANCE TRANSACTIONS

Robert J. Krapf, Esquire*

Many state bars and other professional groups have provided reports on opinion practices, including reports related to opinions on matters governed by the Uniform Commercial Code (U.C.C.). Although the Delaware State Bar Association has not yet produced such a report, a recent report written by three national lawyer associations, and approved by a fourth, can be valuable to lawyers in Delaware who issue opinions in Delaware commercial real estate transactions.

The report on Uniform Commercial Code Opinions in Real Estate Finance Transactions (the “U.C.C. Report”) is a joint project of the American Bar Association Section of Real Property, Trust and Estate Law’s Committee on Legal Opinions in Real Estate Transactions, the American College of Real Estate Lawyers Attorneys’ Opinions Committee, and the American College of Mortgage Attorneys’ Opinions Committee.¹ The American College of Commercial Finance Lawyers also reviewed and approved the report. The U.C.C. Report intends to give guidance to lawyers serving as borrowers’ counsel in mortgage loan transactions, but the extensive background material and guidance in the U.C.C. Report are useful to all lawyers involved in the opinion process.

I. BACKGROUND

The U.C.C. Report project started in 2016 to build on the earlier work that generated the Real Estate Finance Opinion Report of 2012² and the Local Counsel Opinion Report of 2016.³ The U.C.C. Report was undertaken to develop guidance (and an illustrative opinion letter) that reflects current national real estate financing practice on opinions applying the U.C.C. to real estate, real estate-related collateral, and certain personal property typically included in the

* Robert J. Krapf is a retired director and vice president of Richards, Layton & Finger, P.A., in Wilmington, Delaware. This article is for informational purposes only and is not intended to be and should not be taken as legal advice. In addition, this article is the statement by the author only and does not necessarily reflect the views of Richards, Layton & Finger, P.A., any of its other attorneys, or its clients. Portions of this paper also appear in R. KRAPF, DELAWARE COMMERCIAL REAL ESTATE FINANCE LAW AND PRACTICE (2020).

1. Committee on Legal Opinions in Real Estate Transactions, the American Bar Association Section of Real Property, Trust and Estate Law, Attorneys’ Opinions Committee, the American College of Real Estate Lawyers & Opinions Committee, the American College of Mortgage Attorneys (the “Real Estate Opinion Committees”), *Real Estate Opinion Committees, Uniform Commercial Code Opinions in Real Estate Finance Transactions*, 53 REAL PROP. TR. & EST. L.J. 163 (2019) [hereinafter *2019 U.C.C. Report*], https://www.americanbar.org/content/dam/aba/publications/real_property_trust_and_estate_law_journal/v53/ucc-real-estate-finance-report-v53-02.pdf. The 2019 U.C.C. report contains a detailed and thorough analysis of these opinions, including opinions in connection with the pledge of limited liability company interests in a mezzanine loan.

2. Real Estate Committees, *Real Estate Finance Opinion Report of 2012*, 47 REAL PROP. PROB. & TR. L. J. 213 (2012) [hereinafter *2012 Report*]. See also, R. Krapf and E. Levin, *An Overview of the Real Estate Finance Opinion Report of 2012*, 14 DEL. L. REV. 153 (2014).

3. Real Estate Opinion Committees, *Local Counsel Opinion Letters in Real Estate Finance Transactions: a Supplement to the Real Estate Finance Opinion Report of 2012*, 51 REAL PROP. PROB. & TR. L. J. 167 (2016) [hereinafter *LoCo Report*].

security for a commercial real estate loan.⁴ The U.C.C. Report is not a comprehensive guide to all opinions related to the U.C.C. but, in the words of the report itself, “presents building blocks for such opinions, the requirements to give them, and example expressions to provide them in typical real estate finance transactions.”⁵ It also provides references for closer review of the subject matter.⁶

The U.C.C. Report contains four chapters in addition to introductory material and an addendum. Chapter I is a general discussion of concepts applicable to opinions involving the U.C.C. Chapter II discusses in greater detail key components and issues of an opinion involving U.C.C. collateral for a real estate secured transaction. Chapter III addresses specific issues in opinions involving deposit accounts and investment property as collateral. Chapter IV discusses choice of law rules with respect to U.C.C. collateral and the role of assumptions and limitations in U.C.C. opinions. The Addendum contains an illustrative opinion, designed not to serve as a model opinion but merely to illustrate in opinion language and format the components addressed in the preceding chapters.

The U.C.C. Report may serve as an educational tool and a starting point for discussion and consideration by those involved in the opinion process.

II. SUMMARY OF ISSUES IN THE U.C.C. REPORT

What follows is a summary of how the U.C.C. Report addresses certain key elements of opinions on matters governed by the U.C.C., with specific reference to the Delaware U.C.C. This article is not a complete survey of the entire contents of the U.C.C. Report, and reference should be made to the U.C.C. Report itself for more detailed guidance. Finally, this article does not intend to advocate any position with respect to such opinions, but merely to reflect the substance of the U.C.C. Report on these topics.

A. Fixture Collateral

In many routine real estate finance transactions, opinions given on security interests are typically limited to U.C.C. collateral that is comprised of fixtures.⁷ The 2012 Report⁸ notes that “express opinions on security interests in

4. 2019 U.C.C. Report at 166.

5. *Id.* at 166.

6. The subject of opinions on security interests in U.C.C. collateral is treated comprehensively in *Special Report of the TriBar Opinion Committee, U.C.C. Security Opinions-Revised Article 9*, 58 BUS. LAW. 1451 (2003) [hereinafter *TriBar U.C.C. Report*]. More recently, the Opinions Committee of the Business Law Section of the State Bar of California has issued a final exposure draft dated October 9, 2017 of a Sample California Third-Party Opinion Letter for Personal Property Secured Financing Transactions based on reports of several bar organizations as noted therein. For a discussion of personal property security in real estate finance transactions, see P. Ebling & S. Weise, *What A Dirt Lawyer Needs to Know About New Article 9 of the U.C.C.*, 37 REAL PROP. PROB. & TR. L. J. 191 (2002).

7. “Fixtures” are defined in 6 DEL. C. § 9-102(a)(41) as goods that have become so related to particular real property that an interest in them arises under local real property law.

8. The 2012 Report and the *LoCo Report* included a discussion of fixtures because that is the subject related to the U.C.C. addressed most commonly by opinion letters in real estate finance transactions.

personal property other than goods that ... are to become fixtures are not appropriate in real estate secured financings unless the personal property is an important part of the collateral.”⁹ However, some commercial real estate financings require opinions not only on real estate and certain real estate related collateral but also on personal property¹⁰ when that is an important part of the security for the loan, including deposit accounts and investment securities (which can include entity interests in non-corporate entities pledged in mezzanine financing).

When personal property is included in a real estate financing, a security agreement may be incorporated in a mortgage that is to serve as both a mortgage of real property and a security agreement not only as to fixtures but also as to personal property collateral.¹¹ Alternatively, the security interest in personal property collateral may be covered in a separate document that is a security agreement focusing more specifically on personal property collateral. Frequently, counsel is asked to provide opinions as to security interests in both real estate collateral and non-real estate collateral under one or both such documents. For convenience, the U.C.C. Report, and this article, refers to both a mortgage and a security agreement as a “security agreement.”¹²

Opinions about creation, attachment, and perfection of U.C.C. collateral security interests usually are expressed separately as opinions in a third-party opinion letter. Importantly, these opinions are not implicit in a typical enforceability opinion.¹³ If the opinions are desired by the opinion recipient, and agreed to be given by the opinion giver, the opinions must be stated expressly.

Fixtures are likely present in all real estate transactions involving improved real estate.¹⁴ As laws in most states allow for the creation of mortgage liens in fixtures as real property, the execution and delivery of a sufficient mortgage granting a lien on real property will inherently grant a real property lien on the fixtures.¹⁵ If the security agreement grants

9. 2012 Report Ch. Three, para. 3.6(c) at 243. See also Attorneys’ Opinion Comm., American College of Real Estate Lawyers & Comm. on Legal Opinions in Real Estate Transactions, Section of Real Property Probate & Trust Law, American Bar Association, *Real Estate Opinion Letter Guidelines*, 38 REAL PROP. PROB. & TR. J. 241 (2003) § 4.0.d at 252 [hereinafter *RE Guidelines*]. Examples of circumstances where personal property collateral might be an important part of the collateral include financings in the hospitality and health-care industries, and financings requiring the use of lockbox and other cash management arrangements in which deposit and securities accounts are elements of the collateral. Another example may arise in the context of mezzanine financing, where the collateral often consists of pledged equity interests in entities that, directly or indirectly, own real estate.

10. The U.C.C. covers many different types of personal property collateral. It generally does not cover real property (such as land, buildings, easements, leases, and (except as to agricultural liens, defined in 6 DEL. C. §9-102(a)(5)) rents or landlord’s liens) other than fixtures and certain other collateral related to real estate for which provision is expressly made. See 6 DEL. C. §§ 9-109(a)(1) and (2) and §§ 9-109(d)(1), (2), and (11).

11. 2019 U.C.C. Report § II.A at 177.

12. 2019 U.C.C. Report § II.A(1) at 178.

13. *TriBar U.C.C. Report* at 1460.

14. Security interests in other real estate related collateral—growing crops, as-extracted collateral, and standing timber to be cut—are discussed in *RE U.C.C. Report* § II.A.6 at 184-186.

15. See 6 DEL. C. § 9-334(b).

a security interest in goods that are or are to become fixtures, then a U.C.C. security interest has also been created.¹⁶ Subject to the U.C.C.'s choice of law rules, the parties may agree that the law chosen to govern the mortgage also governs the creation or attachment of a security interest in fixtures.¹⁷ The law of the jurisdiction where fixtures are physically located will govern perfection of a security interest in fixtures by a fixture filing.¹⁸

1. Perfection

Although sometimes the opinion recipient will request opinions on creation and attachment of the security interest in U.C.C. collateral, typically creation and attachment are assumed by the opinion giver and the focus of the opinion is on the perfection of the security interest.

The opinion recipient sometimes asks the opinion giver to opine that a proposed form of mortgage or a separate U.C.C. financing statement is adequate under applicable Delaware law to serve as a fixture filing upon proper filing. Such an opinion statement does not typically state that the filing of the financing statement effects perfection, but it does state that the proposed financing statement in the form provided is sufficient and is being filed in the correct office for that purpose.¹⁹ This opinion includes by implication an opinion that the financing statement contains all of the information required to serve as a fixture filing.²⁰ A separate opinion to that effect is unnecessary if the foregoing opinion is given.²¹ In this context, the sufficiency and factual accuracy of the legal description of the real property is assumed, implicitly or expressly.²² The foregoing equally applies to a mortgage intended to serve as a fixture filing.

Lenders sometimes request an opinion on the effect of filing the financing statement as a fixture filing; e.g., a perfection opinion.²³ Such an opinion can be given so long as the underlying facts of creation and attachment are assumed to exist or are otherwise addressed.²⁴ Likewise, such an opinion includes by implication the foregoing opinion as to the form of filing. When the mortgage serves as a fixture filing, this opinion statement subsumes an opinion that the Delaware U.C.C. (if Delaware is the physical location of the fixtures) recognizes that recordation of the mortgage is effective to serve

16. 2019 U.C.C. Report § II.A at 177. The utility of granting a U.C.C. security interest in addition to a lien on real estate created by a real estate encumbrance in the mortgage itself is based on the principle that a separate security interest in goods that are or are to become fixtures in limited circumstances will have priority over the interest of a real estate encumbrancer to the extent provided in 6 DEL. C. §9-334. Often a separate security agreement that grants a security interest in goods that are or are to become fixtures provides that the security agreement is to be governed by the law of a jurisdiction other than Delaware.

17. 2019 U.C.C. Report §II.A at 178. See 6 DEL. C. § 1-301.

18. 2019 U.C.C. Report §II.A at 178. See 6 DEL. C. §§ 9-301(2) and (3). Perfection of a security interest in fixtures by the filing of a financing statement that is *not* a fixture filing is governed by the law of the debtor's location. See 6 DEL. C. § 9-301(1).

19. 2019 U.C.C. Report § II.A(3) at 180-181.

20. *Id.* See 6 DEL. C. § 9-502(a).

21. 2019 U.C.C. Report § II.A(3) at 180-181.

22. *Id.*

23. *LoCo Report* § 3.12.

24. 2019 U.C.C. Report § II.A(3) at 182. See 6 DEL. C. §§ 9-310 and 9-502.

as a fixture filing. No opinion is needed on that point alone, or on the subject of a debtor's authorization to file or record the mortgage as a financing statement.²⁵

An opinion letter often contains a statement that a certain office is the place to record the mortgage, and it will use a defined term to designate that office (e.g., "Recorder of Deeds"). In view of the possible need to address personal property collateral in the same opinion letter, and in order to avoid confusion, the U.C.C. Report recommends that one term should be used to designate the office for real estate recordings or real estate collateral filings, including fixture filings, and another term (e.g., "Filing Office") should be used for personal property collateral financing statements.²⁶ Although this terminology reflects general U.C.C. perfection rules, there are some exceptions, such as for transmitting utilities.²⁷ Use of appropriate terminology in the opinion letter is important.

2. Priority

Priority opinions are never implied and should never be requested or given as to real estate collateral security interests, and only rarely as to personal property security interests.²⁸ The U.C.C. recognizes that there may be competing real and personal property security interests in the goods that are or are to become fixtures, and the Delaware U.C.C. contains detailed provisions concerning when a secured party with a security interest in fixtures and growing crops has priority over a real estate encumbrancer.²⁹ The granting of a mortgage covering real property including fixtures and the granting of a security interest in fixtures will place the holder of those interests in the position of both a real estate encumbrancer and a secured party.³⁰

3. Title

Opinions about title to real estate collateral, including fixtures, are not appropriate to be requested or given.³¹ Although it is customary practice to assume expressly that the borrower or debtor has requisite title and rights (or, for U.C.C. purposes, the power to transfer rights) in any property involved in the transaction, the assumption is implicit.³²

25. *2019 U.C.C. Report* § II.A(3) at 182. 6 DEL. C. § 9-509(b) provides that execution of a security instrument itself authorizes the filing of a financing statement.

26. *2019 U.C.C. Report* § II.A(3) at 182.

27. *2019 U.C.C. Report* § II.A(3) at 183. When the debtor is a "transmitting utility" (defined in 6 DEL. C. §9-102(a)(81) as a person primarily engaged in certain specific business listed in the definition that includes a broader range of activity than typical "utilities"), and if Delaware law governs, the office in which to perfect a security interest in collateral, including fixtures, by filing is the Delaware Secretary of State. 6 DEL. C. § 9-501(1)(b).

28. *2019 U.C.C. Report* § II.A(4) at 183.

29. 6 DEL. C. §§ 9-317 through 9-339 contain the ground rules about priority of U.C.C. security interests.

30. *2019 U.C.C. Report* § II.A(4) at 184.

31. *2019 U.C.C. Report* § II.A(5) AT 184. *See RE Guidelines* § 4.0.c, at 252. *See also TriBar U.C.C. Report* at 1468.

32. *Id.*

In addition, commercially available title insurance will insure attachment, perfection, and priority of a secured party's Article 9 security interest in personal property. Title insurance may be considered in lieu of providing or requesting legal opinions and may provide more comprehensive coverage than a legal opinion.

B. Non-Fixture Real Estate Collateral

Although usually U.C.C. opinions in real estate financing transactions address primarily fixtures as real estate collateral, the U.C.C. applies to other types of collateral related to real estate, including oil, gas, other minerals that become as-extracted collateral, and standing timber to be cut.³³ Special rules apply to security interests in these other types of real estate collateral that must be considered in providing an opinion relating to the attachment and perfection of a security interest in them. The U.C.C. Report provides further guidance.

C. Personal Property (Non-Real Estate) Collateral

Opinions as to personal property collateral may be requested and given in real estate finance transactions involving both real estate and personal property collateral. In considering these opinions, the U.C.C. Report cautions the opinion giver to recognize that although a jurisdiction's law may be chosen to govern the security agreement and attachment of a security interest,³⁴ the U.C.C. contains specific choice of law rules that cannot be modified contractually on the subjects of perfection, the effect of perfection or non-perfection, and priority.³⁵

When an opinion on personal property collateral is given, the opinion giver should express a limitation that any opinion regarding security interests in such personal property collateral is given only to the extent that Article 9 of the Delaware U.C.C. governs attachment, perfection, and the effect of perfection or non-perfection of a security interest in that collateral.³⁶

Providing an opinion as to personal property collateral requires competence in the law of personal property security interests. The opinion giver should have or gain the competence to give such an opinion, consult with persons having specific competence in U.C.C. transactions, or decline to give the opinion altogether.³⁷ The report on U.C.C. opinions published by the group of New York-based law firms known as TriBar advises that opinion preparers who do not work with U.C.C. Article 9 regularly should consider whether to involve other lawyers more conversant with the U.C.C.³⁸

When giving non-real estate collateral opinions, the opinion giver must consider the facts or assumptions required to support them and applicable limitations necessary to qualify them.³⁹

33. See 6 DEL. C. §§ 9-102(a)(6) and (44). See *2019 U.C.C. Report* § II.A(6) at 184-186.

34. See 6 DEL. C. § 1-301.

35. See 6 DEL. C. §§ 9-301 through 9-307.

36. See, *2019 U.C.C. Report* § II.B at 186.

37. *Id.*

38. *TriBar U.C.C. Report* at 1454.

39. See, *2019 U.C.C. Report* § IV.B at 205.

1. Perfection

As discussed above with respect to fixture filing opinions, opinions on personal property collateral typically assume creation and attachment of the security interest. Hence, the focus of the opinion is the perfection of the security interest in personal property collateral by the filing of a financing statement. This assurance about perfection is based solely on filing a financing statement⁴⁰ and is intended to exclude fixture filings discussed previously, although the filing of a financing statement covering fixtures at the location of the debtor can perfect a security interest in fixtures even if physically located in another state.⁴¹ In addition to specific provisions concerning the place to file as to certain collateral, the Delaware U.C.C. provides for perfection by means other than filing a financing statement (by possession, control, or automatic), and for some collateral more than one means is applicable, all of which are addressed in the U.C.C. Report with respect to deposit accounts and investment property.⁴²

When the borrower is a registered organization organized in a jurisdiction other than Delaware, and Delaware law is therefore not applicable to perfection by filing a financing statement—a situation common to many local counsel opinions—an opinion on the perfection of a security interest in personal property collateral in which a security interest is granted⁴³ would be inappropriate.⁴⁴ Except when perfection of a security interest in the collateral by filing a financing statement is governed by Delaware law, matters of creation, attachment, and perfection of the security interest typically will be governed by other law, and they inherently are not covered by an opinion applying only Delaware law.⁴⁵

2. Priority

As is the case with real estate liens, opinions as to the priority of a security interest in personal property collateral should not be given in a real estate finance transaction.⁴⁶

3. Title

Opinions about title to, rights in, or power to transfer rights in U.C.C. collateral should be neither requested nor given.⁴⁷ It is customary practice to assume that the debtor has requisite title and rights in any property involved in the transaction. The assumption is implicit.⁴⁸

40. *2019 U.C.C. Report* § II.B(1)(b) at 189. This opinion includes and necessarily subsumes an opinion that the financing statement contains all of the additional information required to serve as a fixture filing. *See* 6 DEL. C. § 9-502.

41. *2019 U.C.C. Report* § II.B(1)(b) at 189; 6 DEL. C. §9-501(a)(2).

42. *2019 U.C.C. Report* § III at 197-203.

43. *See* 6 DEL. C. §§ 9-301 through 9-306.

44. *2019 U.C.C. Report* § II.B(1)(c) at 190.

45. *Id.*

46. *2019 U.C.C. Report* § II.B(2) at 190.

47. *2019 U.C.C. Report* § II.B(3) at 190. *See also TriBar U.C.C. Report* at 1468.

48. *2019 U.C.C. Report* § II.B(3) at 191. *See also* discussion of title insurance in Section II.A.3 *supra*.

III. CONCLUSION

The U.C.C. Report is intended to be a resource for lawyers practicing in the area of secured real estate finance transactions by synthesizing the current state of opinion practices. It can guide both opinion givers and opinion recipients in how best to address important opinion issues, and it therefore should make the opinion process more efficient for all. There is presently no comparable report exclusively describing best practices for opinions in secured real estate finance transactions specific to Delaware. Moreover, opinion practice varies among the law firms involved in such transactions in Delaware. As Delaware has no independent opinion reports of its own, lawyers can look to the U.C.C. Report, including the illustrative opinion letter attached to the report, for helpful guidance in navigating opinion drafting and negotiation for those opinions addressing U.C.C. collateral in real estate transactions.

WORKABLE STANDARDS FOR DETERMINING ALLOWABLE RENT INCREASES IN MANUFACTURED HOUSING COMMUNITIES

Kenneth K. Baar*

A significant number of households in Delaware live in manufactured homes which they own that are on rented lots in manufactured housing communities. Due to immobility of the homes and consequently the peculiar inequality in bargaining power between the land owner and the homeowner associated with such tenancies, in 2013 Delaware passed a “Rent Justification Act,” applicable only to this type of tenancy. Under the Act, annual rent increases in excess of the percentage increase in the Consumer Price Index (“CPI”) must be justified in an arbitration pursuant to the rent adjustment standards in the law if they are contested by the homeowners. In July 2022, amendments to the Act suspended for five years a portion of the standards for allowable rent increases in excess of the CPI and substituted other standards which sunset in five years and amended other provisions of the Act. This article was substantially completed before the 2022 amendments and addresses the Act’s pre-existing provisions, while an addendum briefly describes and comments on the 2022 amendments.

While the standard in the Act for annual allowable rent increases is customary among the manufactured housing community rent legislation which has been adopted in six other states, the standards for setting allowable increases above the increase in the CPI undermine the purposes of the Act. The law mandates the use of rents agreed to by incoming homeowners as a measure of allowable rents for all spaces in a community, subject to a requirement that such increases are phased in. An amendment now in effect for five years exempts new leases of one year or more from the regulation.

I. INTRODUCTION

In Delaware, about 20,000 lots in 182 in manufactured housing communities (commonly known as “mobile home parks”) are rented by those who purchased their home, but not the land on which it is placed.¹ These owned homes on rented lots comprise about five percent of the housing units in Delaware.² In 2013, Delaware adopted a law known as the “Rent Justification Act” to regulate lot rent increases in these communities.³ Under the Act, if a community owner seeks a lot rent increase in excess of the percentage increase in the Consumer Price Index (“CPI”) and the homeowners object, a determination of the allowable lot rent is made through a binding arbitration process.⁴

* J.D., Univ. of California, Hastings College of Law; Ph.D., UCLA (urban planning); admitted to the California Bar.

1. Spreadsheet provided by Delaware Manufactured Home Relocation Authority (“DEMhRA”) to author (Sept. 1, 2021) [hereinafter *DEMhRA Spreadsheet*] (on file with author).

2. See United States Census Bureau, *Quickfacts: Delaware*, <http://www.census.gov/quickfacts/fact/table/de/pst045221> (last visited Feb. 6, 2022) (Showing 443,781 housing units in Delaware as of July 1, 2019).

3. Rent Justification Act, 79 Del. Laws c. 63, § 1 (2013) (codified as amended at 25 DEL. C. §§ 7050-7056 [hereinafter the “Act”]); see also *Bon Ayre Land, LLC v. Bon Ayre Cmty. Ass’n (“Bon Ayre II”)*, 149 A.3d 227, 230 (Del. 2016) (Noting that the Act is commonly known as the “Rent Justification Act”). The Act only applies to lots with manufactured homes owned by tenants and does not apply to lots with homes owned by the community owner (which are covered by the landlord-tenant code). See 25 DEL. C. §§ 7001(A), 7002(c) (2022). For avoidance of doubt, citations to the Act as adopted in 2013 are cited to the Delaware code, while references to the recently adopted amendments to the Act, discussed in the Addendum, are cited to the statute. See *infra* note 155.

4. 25 DEL. C. § 7053. The relevant consumer price index under the Act is defined as the “Consumer Price Index For All Urban Consumers in the Philadelphia-Wilmington-Atlantic City area” or “CPI-U.” *Id.* § 7052(a). The amounts of the annual allowed increases are tied to the average annual increase in the CPI-U over the preceding thirty-six months. *Id.*

The purpose of this article is to propose standards for regulating rent increases which are more objective, logical, and consistent with the purposes of the Act. It was written before substantial amendments to the Act were adopted in July 2022. Section II provides background about the ownership of both manufactured homes and manufactured housing communities in Delaware and regulations of manufactured housing community rents in other states. Section III discusses the Act, its interpretation by Delaware courts, some seemingly illogical results arising from these cases, and how the Act's standards for rent increases differ from those of other states. Section IV sets forth suggestions for reform. An addendum to the article discusses the 2022 amendments to the Act.

The intent of the Act is to shield manufactured homeowners from unreasonable lot rent increases and protect their substantial investments in their manufactured homes, while preserving the rights of community owners to obtain a “just, reasonable, and fair return.”⁵ While the rule authorizing annual rent increases is simple and objective, the application of the standards for determining allowable rent increases above the CPI has been beset with problems.

The process for reviewing proposed lot rent increases in excess of the CPI involves two steps. First a community owner must demonstrate that the proposed lot rent increase is “directly related to operating, maintaining, or improving the manufactured home community.”⁶ However, the Act does not provide any guidance about the meaning of the term “directly related,” and its meaning has been deciphered in widely divergent ways.

In the second step, community owners who satisfy the “directly related” requirement may justify a proposed increase in excess of the CPI increase on the basis of statutorily enumerated factors. Five of the factors relate to the expenses of operating a community, including capital improvements.⁷ One factor is “market rent,” which is defined as the “rent which would result from market forces absent an unequal bargaining position between the community owner and the homeowners.”⁸ While the Act lists these possible justifications, it does not provide direction concerning how they should be weighed in determining what rent shall be permitted.

The lack of specificity in the Act has led to vastly differing and diametrically opposite interpretations of its meaning among arbitrators and courts.⁹ Faced with vague standards, arbitrators and courts have substantially relied on their consideration of the purposes of the Act, which are also very general, in order to resolve uncertainties as to its meaning. Within the past seven years the Delaware Supreme Court has issued six opinions related to the meaning of the Act.¹⁰ Arbitration and court decisions applying the law frequently include comments about the Act's ambiguity, its lack of sense, and/or uncertainty in the meaning of appellate court guidance.¹¹

5. *Id.* § 7050.

6. *Id.* § 7052(a)(2).

7. *Id.* § 7052(c)(1)-(5).

8. *Id.* § 7052(c)(7).

9. See *infra* text accompanying notes 46-73. In one case, an arbitrator explained that its interpretation was the “only way to logically interpret” the law, only to be reversed on appeal. *Bon Ayre II*, 149 A.3d at 235-36. Apart from struggling with the substantive provisions of the law, on more than one occasion, Delaware courts have also strongly criticized the ambiguity of its procedural provisions and standards of review. See *Pot-Nets Coveside Homeowners Ass'n v. Tunnell Cos.*, 2015 WL 3430089, at *5 (Del. Super. Ct. May 26, 2015) (noting that “[a]mbiguity exists within the Act”); *Bon Ayre Land LLC v. Bon Ayre Cmty. Ass'n (“Bon Ayre I”)*, 133 A.3d 559 (Table), 2016 WL 747989, at *2 (Del. Feb. 26, 2016) (describing statute as “confusing at best, incoherent at worst”); *December Corp. v. Wild Meadows Home Owners Ass'n*, 2016 WL 3866272, at *3 (Del. Super. Ct. July 12, 2016) (noting difficulty in interpreting statute whose language “seems to effectively straddle both standards of review”). Another issue has been whether the income and expense information submitted by community owners in order to justify a rent increase is entitled to confidentiality protections. See *Wild Meadows MHC, LLC v. Weidman*, 250 A.3d 751, 760-63 (Del. 2021).

10. See *Rehoboth Bay Homeowners' Ass'n v. Hometown Rehoboth Bay, LLC*, 252 A.3d 434 (Del. 2021); *Wild Meadows MHC, LLC*, 250 A.3d at 751; *Sandhill Acres MHC, LC v. Sandhill Acres Home Owners Ass'n*, 210 A.3d 725 (Del. 2019); *Donovan Smith HOA v. Donovan Smith MHP, LLC*, 190 A.3d 997 (Table), 2018 WL 3360585 (Del. July 10, 2018); *Bon Ayre II*, 149 A.3d at 227 (Del. 2016); *Bon Ayre I*, 2016 WL 747989 (Del. Feb. 26, 2016).

11. See *supra* note 9; *infra* text accompanying note 12.

Adjudications under the Act may be characterized as a dance by arbitrators and courts caught between carrying out the purposes of the Act, interpreting the literal words of the Act, deciding what makes sense, and adhering to the principle of judicial restraint. As one arbitrator noted:

[The Act] allows logical but significantly contrasting arguments to be made by practitioners on both sides of these cases under the Act. In my view, the Act itself needs clarification... These [court] decisions do not explain how a community owner's *return* is computed, nor what *ledger* is involved in the analysis.¹²

More objective and precise provisions would end the need for this dance.

II. BACKGROUND

A. The Nature of Manufactured Home Ownership and Community Ownership

Most manufactured housing community lots in Delaware are concentrated in the larger communities.¹³ Consistent with national ownership patterns of manufactured home communities, ownership in Delaware has consolidated in recent decades. Three entities own about thirty percent of the community lots in the state and ten entities own about half of the lots.¹⁴

Although usually called “mobile homes,” as the U.S. Supreme Court explained in 1992:

Mobile homes are largely immobile as a practical matter, because the cost of moving one is often a significant fraction of the value of the mobile home itself. They are generally placed permanently in parks; once in place, only about 1 in every 100 mobile homes is ever moved A mobile homeowner typically rents a plot of land, called a “pad,” from the owner of a mobile home park. The park owner provides private roads within the park, common facilities such as washing machines or a swimming pool, and often utilities. The mobile homeowner often invests in site-specific improvements such as a driveway, steps, walkways, porches, or landscaping. When the mobile homeowner wishes to move, the mobile home is usually sold in place, and the purchaser continues to rent the pad on which the mobile home is located.¹⁵

In the Rent Justification Act, the Delaware General Assembly noted that “[o]nce a manufactured home is situated on a manufactured housing community site, the difficulty and cost of moving the home gives the community owner disproportionate power in establishing rental rates” and that “[t]he continuing possibility of unreasonable space rental increases in manufactured home communities threatens to diminish the value of manufactured homeowners’ investments.”¹⁶

Nevertheless, ownership of a manufactured home on a rented space in a manufactured housing community offers significant benefits, particularly for retirees or households with below-average income. Even considering the combination

12. *Wild Meadows Home Owners Ass’n v. Wild Meadows MHC, LLC*, Consol. Dkt. 10-2017, at 17 (DEMHRA Jan. 21, 2019) (Gibbs, Arb.). All of the arbitration decisions cited in this article are on file with the author.

13. Thirty-eight percent of the lots rented to manufactured homeowners are in sixteen communities that have over 300 spaces; and sixty percent of the rented lots are in communities with 200 or more spaces. See *DEMHRA Spreadsheet*, *supra* note 1.

14. See *DEMHRA Spreadsheet*, *supra* note 1; see also DEMHRA, Registered Communities as of June 23, 2021 (list of the owner of each community) (spreadsheet on file with author).

15. *Yee v. City of Escondido*, 503 U.S. 519, 523 (1992) (citing Hirsch & Hirsch, *Legal Economic Analysis of Rent Controls in a Mobile Home Context: Placement Values and Vacancy Decontrol*, 35 UCLA L. REV. 399, 405 (1988)).

16. 25 DEL. C. § 7050 (2022).

of the cost of purchasing a manufactured home and paying rent for a space in a manufactured home community, this form of ownership is often more affordable than owning a single-family home or the combined cost of purchasing a vacant plot of land and installing a mobile home. Manufactured housing communities provide opportunities for households to live in a single family detached dwelling with surrounding open spaces even if a single-family home on a separate lot is unaffordable. Apart from providing affordability benefits, communities commonly contain shared social and recreation facilities and frequently perform as supportive social communities.¹⁷

As for community owners, investments in owning manufactured housing communities offer significant advantages relative to investments in other types of rental income properties such as apartments, offices, and retail centers. Manufactured housing community operating costs typically fall within thirty-five to fifty percent of rental income.¹⁸ The balance of rental income—net operating income—is available to cover mortgage payments and provide a return on the cash investment. Due to the captive nature of manufactured housing community tenancies, community owners are insulated from the risks of cycles in market demand, vacancies, and declines in rental income.¹⁹ The lack of risk is reinforced by the fact that rentals of community spaces are part of a three-cornered transaction: rents that incoming homeowners are willing to pay are determined in conjunction with agreeing on a price for the home. If there is a steep increase in the rent, the current homeowner must either pay the higher rate or sell the home. Since the home either cannot be moved to another community or can only be moved at a substantial cost, a homeowner desiring to avoid an increase in the ground rent may be forced to accept a lower price from a prospective purchaser, who will offset a substantial rent increase by paying less for the home.

By the 1990s, real estate investment entities came to view communities as very attractive investments, and moved into an industry formerly dominated by small-time owners of individual communities with personal ties to their residents.²⁰ For decades, real estate newsletters, financial journals, and other commentators have described manufactured home communities as low risk investments offering a host of advantages over investments in apartment buildings.²¹ There has been a continual pattern of consolidation of the ownership of manufactured housing communities among large scale

17. See Andrée Tremoulet, *Manufactured Home Parks: NORCs Awaiting Discovery*, 24 J. OF HOUSING FOR THE ELDERLY 335, 344 (2010) (noting the “personal safety and a sense of community” associated with living in “naturally occurring retirement communities,” or “NORCs”).

18. ROBERT S. SAIA, APPRAISING MANUFACTURED (MOBILE) HOME COMMUNITIES AND RECREATIONAL VEHICLE PARKS 80 (Appraisal Institute 2017).

19. Howard Rudnitsky, *New Life for Old Mobile Home Parks*, FORBES, Nov. 7, 1994, at 44-45 (describing how “owning the ground under a customer’s \$30,000 investment makes timely collection of rents relatively easy”).

20. See *id.*

21. See, e.g., *NAREIT Conference Call Recap*, NAREIT INVESTOR OUTREACH (Dec. 10, 1999) (investments in manufactured housing communities outperforming other types of real estate investments) (on file with author); Frank Rolfe, *Why Investors Like Warren Buffett are Bullish on Mobile Home Parks*, WEALTHMANAGEMENT.COM (April 15, 2011), <https://www.wealthmanagement.com/investment-strategies/why-investors-warren-buffett-are-bullish-mobile-home-parks> (explaining “[t]his locked-in tenant base is what enables park owners to enjoy phenomenally stable revenue figures, even in major recessions.”). In 2020, industry sources noted that while the apartment industry was pummeled by the COVID-19 pandemic and rent moratoriums, manufactured housing community occupancy and income levels remained stable. See Sebastian Obando, *Institutional Investors Bet on Manufactured Housing as Occupancy, Rents Continue to Grow*, WEALTHMANAGEMENT.COM (Sept. 29, 2020), <https://www.wealthmanagement.com/property-types/institutional-investors-bet-manufactured-housing-occupancy-rents-continue-grow>.

national investors.²² Currently, in the U.S. three investment entities each own over 60,000 manufactured housing community spaces.²³

B. Regulations of Manufactured Housing Community Rents in Other States

Delaware is one of seven states with regulations of rent increases in manufactured housing communities. Three states—New York, Rhode Island, and Vermont—have adopted statewide rent legislation applicable only to manufactured home community spaces.²⁴ Rhode Island permits manufactured housing community homeowners to seek binding review of a rent increase on the basis that they are “unreasonable based on park owner’s...total expenses...”²⁵ Vermont permits homeowners to seek a review of increases which exceed the CPI increase by more than one percent.²⁶ Under New York law, adopted in 2021, annual increases in manufactured home community lot rents are limited to three percent, subject to a right to an increase of up to six percent to cover increases in operating costs and capital improvements.²⁷

In three states—California, Massachusetts, and New Jersey—local regulations have been widespread since the 1980s. In California, about ninety cities and counties have adopted manufactured housing community rent stabilization ordinances, which are applicable to roughly 150,000 manufactured home community spaces.²⁸ About twenty-three municipalities in Massachusetts regulate manufactured housing community space rents.²⁹ According to a 2009 survey, over

22. See Ryan Dezember, *Investors Discover There’s Gold in the Mobile-Home Park*, WALL ST. J., Feb. 26, 2020, at B1-2 (describing acquisitions exceeding \$100 million of communities by major investors); see also Rupert Neate, *America’s Trailer Parks: The Residents May Be Poor but the Owners Are Getting Rich*, GUARDIAN, (May 3, 2015 8:00 AM EDT), <https://www.theguardian.com/lifeandstyle/2015/may/03/owning-trailer-parks-mobile-home-university-investment> (describing ability of owners to raise rents and plight of residents who have no other options).

23. See Patrick Revere, *Top 50 Manufactured Housing Community Owners*, (April 15, 2021), <https://www.mhvilla.com/pro/50-top-mh-community-owners-operators/> (listing the number of manufactured housing communities and spaces owned by the top 50 owners).

24. N.Y. REAL PROP. LAW § 233-B (2021); 31 R.I. GEN. LAWS § 31-44.1-2 (2022); VT. STAT. tit. 10, §§ 6252-6253 (2022) (providing that mediation can be requested if the increase is more than one percent above the CPI increase and arbitration can only be requested if mediation fails). Thirty-six states have preempted local rent regulation ordinances. See National Apartment Association, *Rent Regulation*, <https://www.naahq.org/advocacy/policy-issues/rent-regulation> (accessed Mar. 9, 2022).

25. 31 R.I. GEN. LAWS § 31-44.1-2(b)-(c) (2022).

26. VT. STAT. tit. 10, §§ 6252(a) & 6253(a) (2022).

27. N.Y. REAL PROP. LAW, § 233B(2), (6) (2022). Increases above six percent must be justified under a “hardship” standard and are limited in duration. *Id.* § 233B(6).

28. See *California MHP Rent Stabilization Ordinances (RSO aka SRSO)*, Mobile Home Park Owners Allegiance, <https://mhphoa.com/ca/rso/> (last visited May 4, 2022) [hereinafter *California MHP Rent Ordinances*] (providing a summary of rent increase standards under each local ordinance, the date of adoption, and data on the number of communities and lots in each jurisdiction). Two jurisdictions, Riverside County and San Jose have over 10,000 manufactured housing community lots, and seven other jurisdictions have over 3,000 community lots. *Id.* Given that two of these municipalities have, on their own, half as many lots as Delaware and that the other seven have a substantial number of lots, their legislation may serve as a valuable resource for drafting workable laws. Ordinances which have been adopted within the past decade take into account the fair return precedents of the past few decades and contain more detailed standards regarding fair return and treatment of expenses. See, e.g., HUMBOLDT CNTY., CAL., CNTY. CODE, §§ 9101-10 to -12 (2021), <https://humboldt.county.codes/>.

29. See Peter Benjamin, *Mobile Homes*, in LEGAL TACTICS TENANTS’ RIGHTS IN MASSACHUSETTS 373, 377 (Annette R. Duke, ed., 2017) (listing cities with regulations of mobile home park rents), <https://www.mlri.org/publications/tenants-rights-in-massachusetts-private-housing/>.

one hundred New Jersey municipalities have adopted rent control ordinances; at least ten of the ordinances apply only to manufactured housing communities.³⁰

With few exceptions, the local ordinances in California and New Jersey authorize annual increases.³¹ Usually the amount of the allowable increases is tied to the either the full percentage increase in the CPI or to a portion of the increase.³² Some of the ordinances place a ceiling on the percentage increase that is allowed under the CPI standard.³³ Under the Massachusetts ordinances, a board is authorized to adopt annual increase allowances.³⁴

Apart from the annual allowable rent increases, three types of rent adjustment mechanisms are common among the laws of the other states.

1. *Fair Return Adjustments.* Under every rent regulation owners may obtain rent adjustments in order to be permitted a rent which provides a fair return. Fair return issues and standards are discussed in detail in section V.1.B of this article.

2. *Cost Passthroughs.* A significant portion of the California ordinances allow increases based on “passthroughs” of increases in specified types of operating expenses or capital improvement costs.³⁵ Commonly, the passthroughs are contained in ordinances that limit annual rent increases to less than the annual increase in the CPI, commonly 60 to 80% of the percentage increase.³⁶ Generally, passthroughs are limited to capital improvements and types of costs which are beyond the control of a community owner, such as increases in property taxes, other government mandated fees, or utility costs. There is a great deal of variety among the passthrough provisions, including: caps on passthrough amounts; limitations to capital improvements necessary to maintain a community (rather than new facilities, unless approved by a majority of the homeowners); and limits on passthroughs to a portion of capital improvement costs.³⁷

Passthrough allowances offer the advantage of simplicity because they do not require consideration of overall income and expense information. On the other hand, they allow for additional rent increases even if the annual rent adjustments and other types of allowable increases are already adequate to cover cost increases and provide a fair return.

3. *Additional Increases Upon In-Place Sales of Mobile Homes.* Another rent adjustment method has been to allow additional rent increases when a manufactured home is sold in-place. About one third of the California ordinances and

30. See N.J. Dept. of Cmty. Affs., Div. of Codes and Standards, Landlord-Tenant Info. Serv., *2009 Rent Control Survey* (2009) [hereinafter “New Jersey Rent Ordinances”], https://www.nj.gov/dca/divisions/codes/publications/pdf_lti/rnt_cntrl_srvy_2009.pdf.

31. See *id.*; *California MHP Rent Ordinances*, *supra* note 28.

32. See *supra* note 31.

33. See, e.g., CONTRA COSTA CNTY, CAL., ORDINANCE CODE § 540-2.404(a)(2) (2022), <https://www.contracosta.ca.gov/1210/Codes-Ordinances>; BOROUGH OF FRANKLIN, N.J., CODE § 176-18(C)(3) (2021), <https://ecode360.com/FR1843>; see generally *California MHP Rent Ordinances*, *supra* note 28; *New Jersey Rent Ordinances*, *supra* note 30.

34. See, e.g., SPRINGFIELD, MASS., MUN. CODE § 16-54(A) (2021), <https://ecode360.com/SP2105>.

35. See, e.g., SANTA ROSA, CAL., CITY CODE §§ 6-66.040(C)-(D) (2021), <https://qcode.us/codes/santarosa/view.php> (allowing pass through for government mandated expenses and utilities charges); WASHINGTON, N.J., MUN. CODE § 184-2(A) (2019), <https://ecode360.com/WA0294> (including passthrough for supplied utilities); WALL, N.J., MUN. CODE § 153-35(B) (2020), <https://ecode360.com/WA1959> (including passthrough for major capital improvements).

36. See, e.g., LOS ANGELES CNTY., CAL., CNTY. CODE § 8.57.50(C) (2022), https://library.municode.com/ca/los_angeles_county/codes/code_of_ordinances (limiting annual increase limited to 75% of CPI increase, with a minimum allowance of 3%); *id.* § 8.57.070(D) (passthrough of 50% of capital improvement cost).

37. See, e.g., SANTA CRUZ CNTY., CAL., CNTY. CODE § 13.32.030(D)(5)(g) (2021), <https://www.codepublishing.com/CA/SantaCruzCounty/> (passthrough of 50% of capital improvement cost).

some of the New Jersey ordinances include this type of provision.³⁸ Usually, such increases are limited to five or ten percent or a roughly equivalent dollar amount.³⁹ Limits on the frequency of such increases for the same space are common.⁴⁰

III. DELAWARE’S RENT JUSTIFICATION ACT

The Act authorizes annual increases equal to the percentage increase in the CPI.⁴¹ This approach provides a reasonable balance between the interests of manufactured homeowners and community owners. When both operating costs and rents increase at the same rate as the CPI, “net operating income” increases at the same rate, thereby providing for growth in both income and value. Also, due to typical leveraging aspects of investments in income producing real estate, the returns on actual cash investment are much higher than the rate of return on the total investment.⁴²

The Act also authorizes rent increases in excess of the percentage increase in the CPI if the community owner can satisfy three conditions:

- 1) the owner has not been found in violation of any provision of Title 25, Chapter 70 of the Delaware Code that threatens the health and safety of residents that persists for more than fifteen days;⁴³
- 2) the proposed increase is “*directly related* to operating, maintaining, or improving the manufactured housing community...” *and*
- 3) the increase is “justified by 1 or more factors listed under subsection (c) ...”⁴⁴

38. See *California MHP Rent Ordinances*, *supra* note 28; see, e.g., MARLBORO, N.J., TWP. CODE § 235-11 (2020), <https://ecode360.com/MA0373>.

39. See *California MHP Rent Ordinances*, *supra* note 28.

40. See *id.*

41. See 25 DEL. C. § 7052(a) (2022).

42. For example, if a community is purchased for \$5 million with a typical thirty percent (equity ratio) cash down payment of \$1,500,000 and a mortgage of \$3,500,000, a 30% increase in value from \$5 million to \$6.5 million doubles the owner’s equity from \$1,500,000 to \$3,000,000. See *Colony Cove Props., LLC v. City of Carson*, 220 Cal. App. 4th 840, 876–77 (Cal. Ct. App. 2013) (noting that “one reason for indexing NOI at less than 100 percent of the change in the CPI” is that “real estate is often a leveraged investment” in which “[t]he investor invests a small amount of cash, but gets appreciation on 100 percent of the value” (quoting *Los Altos El Granada Investors v. City of Capitola*, 139 Cal. App. 4th 629, 640 (Cal. Ct. App. 2006))).

43. One superior court decision holds that violations of other health and safety provisions do not implicate this provision. See *Winterset Farms Homeowners’ Ass’n Inc. v. Winterset Farms, LLC*, C.A. No. N20A-12-010 DJB (Order) (Del. Super. Dec. 29, 2021) (order affirming in part and modifying arbitration order) (holding that violation of county sewer code, despite posing a “significant risk to the public health and welfare,” is not a factor in setting rents under the Rent Justification Act, which only refers to violations Chapter 70 of the State Code).

44. 25 DEL. C. § 7052(a)(1)–(2) (2022) (emphasis added).

The third condition's enumerated factors include operating expenses and market rent.⁴⁵

A. Step One – The “directly related” standard

The Act does not specify how to determine whether a proposed rent increase is “directly related” to operating, maintaining, or improving the manufactured home community. The question is critical because, as described below, community owners who satisfy this condition have been able to obtain proposed rent increases with an amount determined solely by the market rent factor, rather than the amount of the “directly related” cost.⁴⁶ Thus, an owner desiring an increase to market rent can undertake an improvement at a minimal cost and consequently justify a substantial rent adjustment based on market rents.

Since the adoption of the Act, the lack of a definition of “directly related” has opened the door to a range of radically differing opinions about its meaning among arbitrators and courts, drastically diverging outcomes in rent arbitration hearings, and a lot of litigation. One end of the spectrum in regard to the meaning of “directly related” includes views that a proposed increase may meet this standard if it is connected to a desire to bring rents to market levels,⁴⁷ or a desire to undertake capital improvements, or some initial steps toward undertaking capital improvements (as opposed to completing them).⁴⁸ A more common concept has been that a proposed rent increase is “directly related” if any capital improvements have been made or there has been an increase in any type of operating cost.⁴⁹ In other cases, arbitrators and courts have held that “directly related” means that overall costs, rather than just specified costs, have increased.⁵⁰ Others

45. The subsection (c) factors are:

- (1) The completion and cost of any capital improvements or rehabilitation work in the manufactured home community, as distinguished from ordinary repair, replacement, and maintenance.
- (2) Changes in property taxes or other taxes within the manufactured home community.
- (3) Changes in utility charges within the manufactured home community.
- (4) Changes in insurance costs and financing associated with the manufactured home community.
- (5) Changes in reasonable operating and maintenance expenses relating to the manufactured home community including costs for water service; sewer service; septic service; water disposal; trash collection; and employees.
- (6) The need for repairs caused by circumstances other than ordinary wear and tear in the manufactured home community.
- (7) Market rent ... [and]
- (8) The amount of rental assistance provided by the community owner to the homeowners under § 7022 of this title. *Id.* § 7052(c).

46. See *infra* text accompanying notes 60–70.

47. *Bon Ayre II*, 149 A.3d at 239 (Vaughn, J., dissenting) (“[T]he community owner’s desire to bring rents more in line with market rent is directly related to the operation of the community.”).

48. See *Donovan Smith MHP v. KDM Dev. Corp.*, Dkt. No. 2-2017, at 3 (DEMHRA May 4, 2017) (Rushe, Arb.) (“Furthermore, the Respondent stated they plan on resurfacing the roads but cannot make these types of improvements without a rent increase. This satisfies the modest requirement of producing evidence that suggests that the return on the property has declined.”); *Ruben v. Bon Ayre Land LLC*, Dkt. No. 17-598, at 3 (DEMRHA Sept. 22, 2017) (Kuhl, Arb.) (finding that “an owner may satisfy the first prong [of subsection (c)] with an uncompleted improvement”); *id.* (noting that “I am not deciding that ground must actually be ‘broken’ and that ‘preconstruction preparation can be sufficient, depending on the circumstances.’”). There was no indication in these decisions that implementation of the proposed increase would be contingent on completing the capital improvement.

49. See, e.g., *Sandhill Acres HOA v. Sandhill Acres MHC*, Consol. Dkt. No. 4, 2017, at 6-8 (DEMHRA July 17, 2017) (Sharp, Arb.).

50. See, e.g., *Subset of Affected Lots in Holly Hill Estates v. Holly Hill Estates*, Dkt. No. 6-2017, at 5-6 (DEMHRA Aug. 30, 2017) (Sherlock, Arb.).

have held that in addition to evidence of an increase in overall costs, there must also be evidence that the overall return has been reduced, taking into account revenues as well as costs.⁵¹ In another case, an arbitrator held that “[t]here must be both a substantial relationship and sufficient proportionality between the cost increase and proposed rent increase.”⁵²

As described below, the Delaware Supreme Court has addressed the disputes about the meaning of the “directly related” standard in four opinions, but has not resolved them.

1. *Bon Ayre II*

The Supreme Court first addressed the question in 2016 in *Bon Ayre Land, LLC v. Bon Ayre Community Association* (“*Bon Ayre II*”).⁵³ This opinion provided mixed messages concerning the meaning of “directly related.” One passage indicates that the application of the Act involves preserving the “initial relationship” between the community owner and the homeowners, taking into account “costs and expected profits.”⁵⁴ Another passage could either indicate that evidence of an increase in overall costs, without evidence of overall income, is adequate to meet the “directly related” standard or could mean that evidence about the overall return is relevant.⁵⁵ A subsequent passage enigmatically states that a land owner need only produce “evidence suggesting” that a “return” has declined, implying that information concerning only one expense would be adequate to fulfill the directly related requirement.⁵⁶ One arbitrator, considering *Bon Ayre II*, lamented that “The Supreme Court’s opinion restated the Section 7042(a)(2) [“directly related”] analysis at least four times using varying formulations and without specifying a holding.”⁵⁷

2. *Donovan Smith HOA v. Donovan Smith MHP*

Two years later, the Delaware Supreme Court revisited the issue in *Donovan Smith HOA v. Donovan Smith MHP*.⁵⁸ The Court restated *Bon Ayre II*’s requirements:

In *Bon Ayre* ... we made clear that “the landowner must show that its original expected return has declined, because the cost side of its ledger has grown. If a landowner can show that its costs have gone up, that opens the door to a rent increase based on § 7042(c)’s factors, including market rent.”⁵⁹

51. *Wild Meadows MHC, LLC v. Weidman*, 250 A.3d 751, 759 (Del. 2021) (quoting *Sandhill Acres MHC, LC v. Sandhill Acres Home Owners Ass’n*, 210 A.3d 725, 731 (Del. 2019)) (“[B]oth sides of the community owner’s financial statements [income and expenses] bear logically on whether and to what extent a rent increase is ‘directly related to operating, maintaining or improving the manufactured housing community’ under the Act.”).

52. *Murray Manor HOA v. Murray Manor, MHP, LLC*, Dkt. No. 3-2019, at 6 (DEMHRA Dec. 29, 2019) (Lawson, Arb.) (emphasis omitted).

53. 149 A.3d 227 (Del. 2016).

54. *Id.* at 234 (“The Act protects homeowners by preserving the initial relationship between themselves and the landowners, which presumably takes into account the landowners’ costs and expected profits.”).

55. *Id.* at 234-235 (“[U]nless the landowner has seen its costs increase for ‘operating, maintaining or improving the manufactured home community,’ the Rent Justification Act preserves the initial relationship the landowner creates between its revenue and its costs The homeowner ... is protected from material increases in rent unrelated to the costs and benefits of living in the community, and the landowner receives the return it originally anticipated.”).

56. *Id.* On the basis of this guidance, an arbitrator held that a plan to resurface roads along with the owner’s testimony that the rent increase was needed to cover this cost was adequate to meet the “directly related” requirement. *Donovan Smith MHP HOA v. KDM Dev. Corp.*, DEMHRA, Dkt. 2, 2017, at 3 (May 4, 2017) (Rushe, Arb.).

57. *Rehoboth Bay HOA v. Hometown Rehoboth*, Dkt. No. 9-2017, at 9 (DEMHRA March 1, 2018) (Spence, Arb.).

58. 190 A.3d 997 (Table), 2018 WL 3360585 (Del. July 10, 2018).

59. *Id.* at *1.

However, this statement does not clearly resolve whether a property owner could rely solely on evidence that the “cost side of [the] ledger” went up or must submit evidence that its overall return has declined, taking into account both increases in operating expenses and rental income.

3. *Sandhill Acres MHC, LC v. Sandhill Acres Home Owners Association*

The next year, the Supreme Court revisited the “directly related” standard in *Sandhill Acres MHC, LC v. Sandhill Acres Home Owners Association*.⁶⁰ In this case, the community owner provided evidence of an expenditure of \$12,185 for a new water filtration system and data in support of an annual rent increase of \$53,760 based on a market rent justification but did not provide evidence regarding overall costs or income.⁶¹ Once again, the arbitrator, the Superior Court, and the Supreme Court reached divergent conclusions about the meaning of the Act’s “directly related” requirement.

The Arbitrator, relying on *Bon Ayre II*, rejected the homeowners’ argument that a property owner must provide evidence of reduced profit margins, instead concluding that a community owner could rely solely on evidence of a capital improvement to meet the “directly related” requirement.⁶² The Superior Court, also relying on *Bon Ayre*, reversed the Arbitrator’s decision.⁶³ It held that evidence about only one cost, without evidence about overall costs, was insufficient.⁶⁴

On appeal, the Supreme Court, also relying on *Bon Ayre II*, overturned the Superior Court, holding that it “suffices for the community owner to offer evidence that in making some capital improvement, the community has incurred costs that are likely to reduce its expected return.”⁶⁵ However, it noted that the homeowners could have rebutted a “directly related” claim “by offering evidence ... for example ... that the expenditure was offset by reduced expenses in other areas,” but indicated that in this case the residents failed to request cost information a timely manner.⁶⁶ While the court reversed the Superior Court, it agreed with its holding that consideration of “*both sides* of the community owner’s financial statements bear logically on whether and to what extent a rent increase is ‘directly related to operating, maintaining or improving the manufactured housing community’ under the Act.”⁶⁷

The Supreme Court also addressed whether and under what conditions a capital improvement expenditure could fulfill the “directly related” requirement when the justification of the amount of the requested annual rent increase was based solely on the market rent factor. The court held that in order to fulfill the directly related requirement: “there should be a material capital expenditure ... that has a substantial relationship to the rent increase sought.”⁶⁸ It explained

60. 210 A.3d 725 (Del. 2019).

61. *Id.* at 729-30.

62. *Sandhill Acres HOA v. Sandhill Acres MHC*, Consol. Dkt. No. 4, 2017, at 19 (DEMHRA July 17, 2017) (Sharp, Arb.).

63. *Sandhill Acres Home Owners Assoc. v. Sandhill Acres MHC, LLC*, 2018 WL 4613716 (Del. Super. Sept. 18, 2018).

64. *Id.* at *5 (“A community owner must show an increase in its costs such that its expected return has declined in order to move to market rent for its existing residents.”).

65. *Sandhill Acres*, 210 A.3d at 728-29.

66. *Id.* This case was one of several cases in which burden of proof and procedural issues have been raised and in which the manufactured homeowners have tripped over failures to request information in a timely manner. *See also* *Donovan Smith HOA v. Donovan Smith MHP, LLC*, 190 A.3d 997 (Table), 2018 WL 3360585, at *3 (Del. July 10, 2018).

67. *Sandhill Acres*, 210 A.3d at 731. To this end, the Supreme Court held that a community owner “must make a choice. Refrain from seeking an increase above inflation and thus be able to keep its information to itself ... or ... be willing to incur the concomitant requirement to justify that increase.” *Id.*

68. *Id.* at 729.

that although the requirement was “modest,” it was not “toothless.”⁶⁹ By example, the court noted that an improvement that cost only \$1,000 would not be considered to be directly related to a proposed annual rent increase of \$25,000, but concluded that the cost of \$12,185 for a water filtration system was a “material percentage of the proposed annual increase” of \$53,760.⁷⁰ Consequently, by undertaking this very modest expenditure, the community owner was able to obtain a rent increase on the basis of the market rent factor that would garner an additional \$268,900 in just the next five year period.

4. *Wild Meadows MHC, LLC v. Weidman*

Most recently, in December 2021, the Supreme Court reiterated its *Sandhill Acres* holding in *Wild Meadows MHC, LLC v. Weidman*.⁷¹ It repeated that “both sides of the community owner’s financial statements bear logically on whether and to what extent a rent increase is ‘directly related to operating, maintaining or improving the manufactured housing community’ under the Act.”⁷² It explained that such information must be available in order to be able to rebut an owner’s prima facie case by demonstrating that an “expenditure did not in fact reflect any increase in costs—for example because the expenditure was offset by reduced expenses in other areas.”⁷³

Up to now there been a substantial amount of litigation over the meaning of the “directly related” requirement and whether a community owner seeking a rent increase has met this standard. However, in future cases even a more demanding application of the “directly related” standard, such as requiring a showing of an increase in overall costs or a decline in net revenues, may only amount to a speed bump on the way to consideration of the market rent factor. As one arbitrator concluded: “A community owner can tie virtually any expenditure (other than acquisition costs and debt service ...) to ‘operating, maintaining, or improving’ the community.”⁷⁴ Normal fluctuations in overall expenses, combined with discretion in the timing of substantial maintenance or capital improvement expenditures, can easily result in increases in overall operating expenses and/or downward fluctuations in net operating income which provide a basis for meeting the “directly related” requirement.

Delaware’s “directly related” hurdle is unique among rent legislation. Typically, manufactured housing community rent laws provide that once a review process is triggered, it involves consideration of all the factors that are relevant to that review, rather than including an intermediate “directly related” hurdle.⁷⁵

B. Step Two – The Subsection C Factors

Once the “directly related” standard has been satisfied, two aspects of the Subsection C factors raise substantial issues. First, the market rent factor appears to be at cross-purposes to the General Assembly’s stated purposes in adopting the Act. Second, it is unclear whether adjudications pursuant to this Subsection should consider of all of the listed factors, or only those raised by a manufactured home community owner in its application.

69. *Id.*

70. *Id.*

71. 250 A.3d 751 (Del. 2021).

72. *Id.* at 759 (emphasis added) (citing *Sandhill Acres*, 210 A.3d 729).

73. *Id.* at 758 (citing *Sandhill Acres*, 210 A.3d 729).

74. *Wild Meadows Home Owners Ass’n v. Wild Meadows MHC, LLC*, Consol. Dkt. 10-2017, at 17 (DEMHRA Jan. 21, 2019) (Gibbs, Arb.).

75. *E.g.*, SAN JOSE, CAL., MUNI. CODE §17.22.700 (2022), https://library.municode.com/ca/san_jose/codes/code_of_ordinances (“all documentation upon which the landlord relied in determining the proposed rent increase ... [including] a statement of the operating expenses” must be submitted in order to commence the arbitration process).

1. The “Market Rent” Factor

The market rent factor rests uneasily with the purposes of the Act and its underlying premise that rent increase regulations are necessary to alleviate the outcomes of the unregulated market and to protect homeowners from rent increases that will reduce the value of their homes. The first part of this standard, which was included in the original Act in 2013, defines market rent as “that rent which would result from market forces absent an unequal bargaining position between the community owner and the homeowners.”⁷⁶

However, there is no accepted or even common understanding of what market would meet this condition or what methodology could be used to determine such a rent. A host of regulatory constraints govern how the market works and sway the relative bargaining powers of community owners and manufactured homeowners. The concept that one could determine what the rents would be in a market “absent unequal bargaining position[s]” is illusory. One may ask, would this mean: 1) a market in which manufactured homes and communities could be placed anywhere it was safe to do so, without being restricted by zoning rules, or 2) a market in which a significant supply of vacant spaces is available in competing communities, or 3) a market with technology that enabled the movement of manufactured homes from one community to another at a low cost combined with a willingness of community owners to accept homes without age or size restrictions?

The New Jersey Supreme Court once proposed and then withdrew a similar rubric in the context of controls of apartment rents.⁷⁷ In 1975, the New Jersey court stated that fair return could be based on the rents in a “*market free of the aberrant forces* which led to the imposition of controls.”⁷⁸ However, three years later the court noted that “[n]one of the witnesses had performed such an analysis before; none knew of any recognized appraisal method for making hypothetical equilibrium valuations.”⁷⁹ The court concluded that “a value-based criterion for confiscation under rent control is practically unworkable.”⁸⁰

In 2014, the market rent factor in the Delaware Act was amended to provide for consideration of the rents agreed to by incoming homeowners: “In determining market rent relevant considerations include rents charged to recent new homeowners entering the subject manufactured home community and/or by comparable manufactured home communities”⁸¹ *In Bon Ayre II* the Supreme Court described this approach as a “fair way” to consider market rents, “[b]ecause new homeowners have not yet made the investment ... and are therefore unencumbered by switching and investment costs that could distort the value of a given location...”⁸² In *Sandhill Acres* the court further affirmed the use of this measure.⁸³

76. 25 DEL. C. § 7052(c)(7) (2002).

77. See *Troy Hills Village v. Council of the Township of Parsippany-Troy Hills*, 350 A.2d 34, 44 (N.J. 1975).

78. *Id.* (emphasis added).

79. *Helmsley v. Borough of Fort Lee*, 394 A.2d 65, 72 (N.J. 1978).

80. *Id.*

81. 25 DEL. C. § 7052(c)(7) (2022).

82. *Bon Ayre II*, 149 A.3d at 237-238 (emphasis added).

83. *Sandhill Acres*, 210 A.3d at 730 n.31 (stating that market rent factor serves “not just the interests of community owners” but also “the interests of homeowners by focusing the inquiry on the rent paid by new entrants not subject to the compromised bargaining position of existing homeowners”). The Superior Court had reached the opposite conclusion. *Bon Ayre Community Ass’n, Inc. v. Bon Ayre Land, LLC*, 2016 WL 241864, at *8 (Del. Super. Jan. 12, 2016) (“allowing an increase based solely on market rent could lead to situations where a homeowner is faced with an unreasonable or burdensome increase in rent even when there is no threat to a community owner’s just, reasonable, and fair return on their investment.... [a]llowing a community owner to increase rent based solely on a market rent justification does not balance the rights of the homeowner and the community owner.”).

While endorsing this approach on two occasions, in *Bon Ayre II* the court also carefully indicated that the rents charged to new homeowners were not the only “permissible types of evidence” of what would be considered as market rents for the purpose of the Act.⁸⁴ Nevertheless, in the context of an absence of any known methodology for calculating what the rents would be in a “market absent an unequal bargaining position,” the rent agreed to by incoming homeowners has become the only type of evidence that possibly can be produced in regards to the market rent factor.⁸⁵

While the Delaware Supreme Court has concluded that the rents agreed to by incoming manufactured housing purchasers reflect ordinary market conditions, federal and state courts in other jurisdictions have come to virtually opposite conclusions. Instead, those courts have recognized a phenomenon that is peculiar to setting rents in manufactured housing communities (as opposed to affecting how apartment rents are set): an interplay between the rents and the prices that are paid for mobile homes.⁸⁶ As one federal appellate court explained, the “value of the rent controls is figured into the total purchase price and ‘capitalized’ into the value of the mobilehome”⁸⁷ Conversely, in the absence of rent regulation the community owner can capitalize the value of the manufactured home into the lot rent. A significant increase in the rent rather than being “absorbed” by an incoming homeowner, is absorbed by the departing homeowner in the form of a reduction in the price that the incoming homeowner is willing to pay for the home.

A Federal Circuit Court of Appeals opinion, relying on a report prepared by the community owner’s expert witness, noted the magnitude of the interplay between rents and manufactured home values:

[An] expert’s report ... explain[ed] that rents for sites in their mobile home park would average about \$13,000 a year without rent control, but average less than \$3,300 with rent control, and that the tenants could sell their mobile homes for around an average of \$14,000 without rent control, but because of rent control, the average mobile home in the park sells for roughly \$120,000.⁸⁸

While the stated purpose of the Act is to “protect the substantial investment made by manufactured homeowners,”⁸⁹ the market rent standard authorizes rent increases that enable a community owner to incorporate a portion of the value of a manufactured home into the rent.

Also, the market rent standard undermines a central protection of Delaware’s Manufactured Homes and Manufactured Home Communities Act.⁹⁰ That law provides that manufactured homeowners can assign their rights under their rental agreement, including the rental amount, to the incoming purchaser of their manufactured home.⁹¹ However, if a community owner can reset the rents for manufactured homeowners at a market level, any protection provided by the right of an incoming homeowner to assume the selling homeowner’s rent level can effectively be extinguished.

84. *Bon Ayre II*, 149 A.3d at 237 (noting that the Act “provides examples of evidence, rather than an exclusive list”).

85. *See, e.g.*, *Sandhill Acres HOA v. Sandhill Acres MHC*, Consol. Dkt. No. 4, 2017, at 8–17 (DEMHRA July 17, 2017) (Sharp, Arb.) (arbitrator’s discussion of “market rent” issues).

86. *See, e.g.*, *Guggenheim v. City of Goleta*, 638 F.3d 1111, 1115-16 (9th Cir. 2010); *Yee v. City of Escondido*, 224 Cal. App. 3d 1349 (Cal. Ct. App. 1990).

87. *MHC Financing Limited Partnership v. City of San Rafael*, 714 F.3d 1118, 1122 (9th Cir. 2013).

88. *Guggenheim*, 638 F.3d at 1115-16.

89. 25 DEL C. § 7050 (2002) (“The continuing possibility of unreasonable space rental increases in manufactured home communities threatens to diminish the value of manufactured homeowners’ investments. Through this subchapter, the General Assembly seeks to protect the substantial investment made by manufactured homeowners.”).

90. *Id.* §§ 7006–22.

91. *Id.* § 7013(d)(1).

Community owners in New Jersey and California have contended that if community owners are not permitted to raise the lot rents of incoming home purchasers to market levels upon in-place sales there is an unconstitutional taking.⁹² The theory underlying these claims has been that even if the laws permit rent levels which provide a fair return, upon in-place sales they allow homeowners to capture benefits of rent regulations which rightfully belong to community owners (known as the “premium” theory).⁹³ In a unanimous opinion in *Yee v. Escondido*, the U.S. Supreme Court rejected this type of claim, concluding that shifts in value are an ordinary outcome of regulation, rather than a “physical” taking.⁹⁴ Subsequently, when challenges based on the same premium theory relied regulatory taking claims, they were also rejected.⁹⁵

2. A Balance in the Application of the Subsection (C) Factors

The Act requires that the proposed rent increase above a CPI increase must be “justified by 1 or more factors listed under subsection (c) of this section.”⁹⁶ However, the Act does not specify whether an arbitrator may consider the factors that are not raised by the community owner and does not indicate whether factors which are not listed but relate to the purpose of the Act may also be considered.

As discussed above, when community owners have offered a market rent justification for a rent increase, arbitrators have ruled that rents may be increased up to that amount without considering what amount would be justified on the basis of the cost factors in Subsection (C).⁹⁷ The dissent in *Bon Ayre II* questioned this approach on the basis that it did not provide for consideration of the “particular circumstances” of each case in order to carry out the purposes of the statute:

Since market rent “may” justify an increase in rent, there can be cases where it may not. While the statute provides that an arbitrator is to employ the standards set forth in § 7042, I believe that the statute gives an arbitrator the discretion to apply them with a view toward satisfying the purposes of the statute. In my view, an arbitrator can exercise discretion to deny a proposed increase to market rent if, in the particular circumstances of the case, doing so would be unreasonable or burdensome to the homeowners.⁹⁸

However, the majority opinion did not address this interpretation of the Act.

92. See *Hall v. Santa Barbara*, 833 F.2d 1270 (9th Cir. 1987); *Pinewood v. City of Barnegat*, 898 F.2d 347 (3d Cir. 1990). Both *Hall* and *Pinewood* were abrogated by *Yee v. City of Escondido*, 503 U.S. 519 (1992).

93. See *Guggenheim*, 638 F.3d at 1126; *MHC Financing Ltd. Partnership v. City of San Rafael*, 714 F.3d 1118, 1128 (9th Cir. 2013).

94. *Yee*, 503 U.S. at 529–30 (1992) (“Petitioners emphasize that the ordinance transfers wealth from park owners to incumbent mobile homeowners. Other forms of land use regulation, however, can also be said to transfer wealth from the one who is regulated to another.”).

95. See *MHC Financing Ltd. Partnership*, 714 F.3d at 1126–29 (holding that rent control ordinance did not constitute a regulatory taking); *Guggenheim*, 638 F.3d at 1118–22 (same); *Cashman v. Cotati*, 415 F.3d 1027 (9th Cir. 2005) (upholding rent control ordinance and withdrawing earlier opinion finding regulatory taking based on failure “to substantially advance a legitimate government interest” after ruling in *Lingle v. Chevron USA Inc.*, 544 U.S. 528 (2005)); *Rancho de Calistoga v. City of Calistoga*, 800 F.3d 1083, 1092 (9th Cir. 2015) (rejecting “private takings claim”).

96. 25 DEL C. § 7052(a)(2) (2002).

97. See, e.g., *Sandhill Acres HOA v. Sandhill Acres MHC*, Consol. Dkt. No. 4, 2017, at 16, 20–21 (DEMHRA July 17, 2017) (Sharp, Arb.).

98. *Bon Ayre II*, 149 A.3d 227, 240 (Del. 2016) (Vaughn, J., dissenting).

The Act thus differs from the rent laws of other jurisdictions. While the Act lists factors that may be used by a community owner as justifications for a rent increase in excess of the annual allowable increase, the rent laws in other states generally list what factors “may” or “shall” be considered by the adjudicator,⁹⁹ and commonly include “fair return” and “any other relevant” factors in the list.¹⁰⁰ These laws provide for rent increases adequate to cover increases in operating costs, rather than triggering a right to charge “market rents.”

IV. GUIDELINES FOR REFORMS CONSISTENT WITH THE PURPOSES OF THE ACT

This section provides suggestions for reforms to the Act for the purpose of providing workable standards and outcomes consistent its purposes. These suggestions include: 1) replacing the market rent factor in Subsection C with a “just, reasonable, and fair return” factor, 2) setting forth a methodology for calculating a “just, reasonable, and fair return,” 3) providing more specificity about how operating expenses should be calculated for the purposes of determining allowable rent; 4) replacing the “financing” factor with a uniform interest allowance for capital improvements and operating expenses that are amortized, and 5) providing that proposed increases must be approved before they can implemented.

A. Replace the “Market Rent” Factor with a “Fair Return” Factor

As discussed, one portion of the market rent standard (“market forces absent an unequal bargaining position”) rests on a measure of rent that cannot be performed. The other portion of the standard (the rent agreed to by new tenants) incorporates the peculiar imbalances in how lot rents are set in the context of manufactured housing community rentals. Provision of security of tenure and protection of the investments of manufactured housing owners depends on a system in which rent increases are tied to overall price trends and increases in operating costs. In contrast to the market rent standard in Rent Justification Act, the rent laws of other states set ceilings on rents above annual allowable increases primarily on the basis of “fair return” standards, specific cost passthroughs, and/or limited additional increases upon in-place sales.

B. Establish A Methodology for Determining “Fair Return”

While a purpose of the Act is to permit a “just, reasonable, and fair return,”¹⁰¹ up to now, as far as the author is aware, none of the preceding arbitration decisions have considered what rent would meet that standard. However, the Delaware Supreme Court decisions include statements that overall returns are relevant to meeting the “directly related” requirement.¹⁰² Given these holdings, community owners may no longer be able to obtain rent increases solely on the basis of increases in specified operating costs. Consequently, disputes about what overall returns provide a fair return may take on prominence. In turn, an absence of workable and logical fair return standards may lead to new rounds of uncertainty

99. See, e.g. NEW YORK, REAL PROP. LAW § 233B(2) & (6) (2022) (listing factors that the court “shall take into account” in reviewing a hardship application).

100. E.g., LOS ANGELES CNTY., CAL., CNTY. CODE § 8.57.060(A)(3)(a) (2022); ESCONDIDO, CAL., MUNI. CODE § 29-104(g) (2021), https://library.qcode.us/lib/escondido_ca/pub/municipal_code.

101. 25 DEL C. § 7050 (2022).

102. See *supra* text at notes 65-73.

and litigation.¹⁰³ Here, one type of standard – “maintenance of net operating income” (MNOI) – is strongly recommended. This standard has been repeatedly praised in appellate court opinions and is widely used in the jurisdictions that have a substantial number of manufactured housing community lots.¹⁰⁴ In contrast, other types of standards are fraught with conceptual and practical shortcomings.

Although the concept that the park owners are constitutionally entitled to a “fair return” is undisputed, the task of drafting a fair return standard which is legally adequate, workable and logical requires consideration of judicial precedent and overcoming some common intuitions. In 1993, a California Court of Appeal commented about the complexities of fair return issues:

What appears at first blush to be a simple question of substantial evidence turns out to be something considerably more complex when one realizes that the formula for arriving at a “fair return” is hotly debated in economic circles and has been the subject of sparse, scattered, and sometimes conflicting comment by appellate courts.¹⁰⁵

The right to a fair return is a constitutional right of owners of rental properties subject to rent regulations.¹⁰⁶ Consequently the courts are the final arbiters of what rent is adequate to provide a fair return.¹⁰⁷ While this right is a constitutional right, courts have held that the selection of a fair return standard is a legislative task, and that, at least in California, “[r]ent control agencies are not obliged by either the state or federal Constitution to fix rents by application of any particular method or formula.”¹⁰⁸ At the same time, the courts have held that some types of standards either have no “rational basis,” (a constitutional standard for the validity of legislation), or are circular in a manner that makes their use non-sensical in the context of rent regulations, and/or are fraught with other problems. In the following discussion, the alternate standards are discussed and critiqued. One standard— maintenance of net operating income (“MNOI”)—has been praised by appellate courts and is now widely used under the manufactured housing community rent ordinances in California.

1. Discretionary Standards Without a Fair Return Formula

Some statutes contain lists of discretionary factors, which are often extended to include other relevant factors, to be considered in rent adjustment cases, without setting forth a specific formula or methodology for determining what

103. Numerous sources address fair return standards and jurisprudence. *See* Colony Cove v. City of Carson, 220 Cal. App. 4th 840, 869-870 (Cal. Ct. App. 2013); Kavanau v. Santa Monica Rent Control Bd., 16 Cal. 4th 761, 761-786 (Cal. 1997); Mayes v. Jackson Twp. Rent Leveling Bd., 511 A.2d 589 (N.J. 1986); Fisher v. City of Berkeley, 37 Cal. 3d 644, 678-87 (Cal. 1984); *see generally* Kenneth Baar, *Fair Return under Mobilehome Park Space Rent Controls: Conceptual and Practical Approaches*, 29 REAL PROP. L. REP. 333 (Sept. 2006); Kenneth K. Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS L. REV. 723, 781-817 (1983); (discussing fair return standards); Willis, “Fair Rents” Systems, 16 GEO. WASH. L. REV. 104, 131, 140 (1947).

104. *See infra* text accompanying notes 133-135.

105. Palomar Mobilehome Park Ass’n v. Mobile Home Rent Review Comm’n, 16 Cal. App. 4th 481, 483 (Cal. Ct. App. 1993).

106. *See Kavanau*, 16 Cal. 4th at 771-72.

107. *See* Galland v. City of Clovis, 24 Cal. 4th. 1003, 1026 (Cal. 2001) (discussing that “fair rate of return” is a legal and constitutional, rather than an economic, term).

108. *Kavanau*, 16 Cal. 4th at 768 (citing cases).

rent provides a fair return.¹⁰⁹ This approach is less legislatively burdensome and provides great flexibility for adjudicators. It has proven safe from facial attack as courts have consistently rejected arguments that laws without a set formula are unconstitutionally vague.¹¹⁰ On the other hand, some state supreme courts have roundly criticized such laws, even though they have not ruled that they are unconstitutionally vague.¹¹¹

In the absence of a mandated methodology, fair return hearings become subsumed by legal and policy debates over what methodology should be used to calculate a rent providing a fair return. As adjudicators apply different methodologies, outcomes in such cases become unpredictable and varying.

2. Fair Return on Value

Under a fair return on value standard, a fair return is defined as a net operating income equal to a specified percentage of the value of the regulated property.¹¹² However, in a landmark case involving utility rates, the U.S. Supreme Court concluded that a return on value approach is circular in the context of price regulation.¹¹³ The Court explained that allowable rates “cannot be made to depend upon ‘fair value’ when the value of the going enterprise depends on earnings under whatever rates may be anticipated.”¹¹⁴ Consistent with this concept, California, Massachusetts, and New Jersey appellate courts have rejected claims that owners of rent-controlled properties have a constitutional right to a fair return on the “value” of their property, and have noted the circularity of return on value standards.¹¹⁵

109. See, e.g., N.Y. REAL PROP. LAW § 233B (2022); EASTON, MASS., CODE § 168-5, <https://ecode360.com/32675379> (2021). California ordinances initially adopted in the 1980s commonly include such standards. See, e.g., ESCONDIDO, CAL., MUNI. CODE § 29-104; SONOMA CNTY, CAL., MUNI. CODE § 2-199 (2022), https://library.municode.com/ca/sonoma_county/codes/code_of_ordinances.

110. See *Carson Mobilehome Park Owners’ Ass’n v. City of Carson*, 35 Cal. 3d 184, 190 (Cal. 1983); *Aspen-Tarpon Springs Ltd. v. Stuart*, 635 So. 2d 61, 67-68 (Fla. Dist. Ct. App. 1994). Some California municipalities preferred this approach in the 1980s due to uncertainty about what specific fair return methodologies would be struck down or mandated. Cf. *Oceanside Mobile Home Park Owners’ Ass’n v. City of Oceanside*, No. N17905, at 2 (Cal. Super. Ct., San Diego C’nty, Nov. 24, 1982) (holding that the ordinance is unconstitutional because it does not provide a just and reasonable rate of return on the fair market value of the property); *Cotati Alliance for Better Housing v. City of Cotati*, No. 108247, at 2 (Cal. Super. Ct. Sonoma C’nty, Dec. 23, 1980) (finding maximum rent adjustment unconstitutional where adjustment is tied to return on investment rather than value). Subsequently, the California Supreme Court held that return on value standards are not constitutionally required, concluding that they are circular in the context of rent regulation. See *Fisher v. City of Berkeley*, 37 Cal. 3d 644, at 680-81 (Cal. 1984). Unpublished California trial court decisions are on file with the author.

111. See *Mayes v. Jackson Twp. Rent Leveling Bd.*, 511 A.2d 589, 593 (N.J. 1986) (citing *Troy Hills Village v. Township Council of Parsippany-Troy Hills*, 350 A.2d 34, 42-43 (N.J. 1975) for the proposition that “rent control ordinances should set forth standards and criteria by which the parties, the local rent control agency, and reviewing tribunals can be guided in determining adequacy of returns actually received under the ordinance”); *Yee v. Mobilehome Park Rental Review Bd.*, 17 Cal. App. 4th 1097, 1106 (Cal. Ct. App. 1993) (criticizing regulation that “merely lists factors to be considered by the [Mobile Home Rental Review] Board without specifying their relative impact.”).

112. E.g., SPRINGFIELD, MASS., MUN. CODE § 16-54.B (2021) (“Fair net operating income shall be that income which will yield a return, after all reasonable operating expenses, on the fair market value of the property equal to the debt service rate generally available to from institutional first mortgage lenders”).

113. *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 601 (1944) (modifying holding in *Smyth v. Ames*, 169 U.S. 466, 468 (1898) that regulated utilities were entitled to a fair return on the “value” of their property).

114. *Id.*

115. See *Helmsley v. Borough of Fort Lee*, 394 A.2d 65, 71 (N.J. 1978) (noting “[o]nce income is controlled, however, using capitalization of income to determine value to regulate future income is a circular process” and providing examples of the circularity of a return on value standard); *Fisher*, 37 Cal. 3d at 680, n.33; *Niles v. Boston Rent Control Adm’r*, 374 N.E.2d 296, 301 (Mass. App. Ct. 1978).

3. Fair Rate of Return on Investment

Likewise, in the context of rent regulation, a fair rate of return on investment standard is circular, although it may seem intuitively reasonable. This approach allows investors to set the permissible rent by choosing their level of investment in the property, with the only cap on how much to invest being what rent the market will bear. One federal court has ruled that a lack of return on investment standard in a rent regulation cannot provide a basis for a taking claim,¹¹⁶ and other courts, while not holding that this type of standard cannot be used, have noted its substantial shortcomings.¹¹⁷ Apart from being circular, the rate of return on investment standard is fraught with other failings. Selecting a fair rate is a highly subjective process. Courts have only defined such a “fair” rate in vague, theoretical terms.¹¹⁸ Also, they have reached widely divergent conclusions about how the investment should be calculated and about what rate of return is fair.¹¹⁹ Ultimately, under a rate of return on investment standard a smorgasbord of rationale are available to support widely varying computations of the amount of the investment and of a reasonable rate.¹²⁰

4. A Fair Ratio of Net Operating Income to Gross Income

Under a fair ratio of net operating income to gross income standard, a property owner is entitled to a rent increase if the ratio of net operating income to gross rental income is below a designated percentage.¹²¹ The drawback of this standard is that it establishes a uniform net operating income to gross rental income ratio as fair, when, in fact, these ratios vary can widely among rental markets.¹²² Owners with net operating income ratios above the fair return level cannot obtain increases to cover increases in operating costs even if those increases exceed allowable increases in rent. On

116. *Cf.* *Rent Stabilization Ass’n v. Dinkins*, 805 F. Supp. 159, 163 (S.D.N.Y. 1992) (noting “such a standard would be ‘unfair’ because it would favor those who paid more over those who paid less for their investments,” relying heavily on the more expansive reasoning about fair rate of return on investment claims in *Park Avenue Tower Associates v. City of New York*, 746 F.2d 135, 138-140 (2d Cir. 1984)).

117. *See, e.g.*, *Fisher v. City of Berkeley*, 37 Cal. 3d 644, 691-92 (Cal. 1984) (“[T]he [return on investment] standard has the potential for awarding windfall returns to recent investors whose purchase prices and interest rates are high. If this latter aspect were unregulated, use of the investment standard might defeat the purpose of rent price regulation.”).

118. *See Hutton Park Gardens v. West Orange*, 350 A.2d. 1, 16 (N.J. 1975) (“[T]he return should be one which is generally commensurate with returns on investments in other enterprises having comparable risks. Determination of what level of return is ‘just and reasonable’ involves evaluation not only of the interests of the investor but also of the interests of the consumer and of the general public sought to be advanced by the regulatory legislation.”); *Kavanau*, 16 Cal. 4th at 771-772.

119. For three diverse holdings about how to calculate the investment, consider *Cotati Alliance for Better Housing v. City of Cotati*, 148 Cal. App. 3d 280, 289 (Cal. App. 1983), which held that historic investment may be adjusted by inflation in applying a return on investment standard; *Mayes v. Jackson Twp. Rent Leveling Bd.*, 511 A.2d 589, 596 n.7 (N.J. 1986), where the court noted that “increasing an investment base to adjust for inflation is not a constitutional imperative, [but] it would be an almost complete answer to a claim of confiscation”; and *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Comm.*, 16 Cal. App. 4th 481, 487-89 (Cal. App. 1993), in which the court determined that accumulated depreciation should be deducted from historic investment in order to compute investment.

120. *See* Ben Lewis, *Emphasis and Misemphasis in Regulatory Policy*, in *UTILITY REGULATION* 212, 242-243 (William G. Shepherd & Thomas G. Gies eds., 1966) (noting that in disputes over a fair rate “expert contrived presentations ... are turned into veritable witches’ brews of statistical elaboration and manipulation”).

121. *See, e.g.*, *BOROUGH OF FRANKLIN, N.J., CODE § 176-23(A)* (2021), <https://ecode360.com/FR1843>.

122. *See Mayes*, 511 A.2d at 380-381 (citing studies by author and others).

the other hand, if an owner's net operating ratio is below the minimum, the standard provides incentives to undertake excessive operating costs.¹²³

5. Maintenance of Net Operating Income

The maintenance of net operating income ("MNOI") standard is based on the concept that rent increases under rent regulations should be adequate to cover increases in operating costs and provide for growth in net operating income commensurate with the percentage increase in the CPI. For example, if fair net operating income is defined as base period net operating income adjusted by 100% of the rate of increase in the CPI, where an owner's net operating income was \$500,000 in the base year, and the CPI has increased by twenty percent since then, the current fair net operating income in the current year would be \$600,000. The MNOI standard differs from rate of return on investment or return on value standards because it is based on a comparison of the base year and current year net operating income, rather than only considering the return in the current year.¹²⁴

Notably, in calculating net operating income, debt service is not considered as an operating cost.¹²⁵ Thus, all owners have a right to an equal rate of growth in NOI regardless of differences in their length of ownership and investment and financing arrangements. Under the MNOI standard, an investor must determine what investment and financing arrangements will make sense if the rate of growth in net operating income may be limited to the rate of increase in the CPI.

By providing a right to charge rents that will provide for growth in net operating income, the MNOI standard allows growth in the return that is available to pay for increases in debt service, to fund capital improvements, and/or to provide additional return on cash investment. Growth in net operating income also provides for appreciation in the value of a property.¹²⁶ This approach meets the twin objectives of protecting tenants from excessive rent increases that are not justified by operating cost increases and increases in the CPI, and of providing regulated owners with an increasing return on their investment.¹²⁷ As one California Court of Appeal has noted, MNOI provides the "best available option" for regulating rent levels.¹²⁸

123. For example, in order to maintain a net operating income ratio of 50%, for each \$100,000 in additional operating expenses, an additional \$200,000 in gross income is required.

124. While the courts have held that no particular type of fair return standard is constitutionally required, also they have held that not permitting growth in net operating income is confiscatory. *Helmsley v. Borough of Fort Lee*, 394 A.2d 65, 76 (N.J. 1978); *Fisher v. City of Berkeley*, 37 Cal. 3d 644, 683 (Cal. 1984). The MNOI standard is the only type of standard which considers this factor.

125. See, e.g. *SAN JOSE, CAL., MUNI. CODE* § 17.22.540(B)(1) (2022). Typically, the exclusions set forth an exception for cases in which refinancing is compelled by the terms of a mortgage entered into prior to the adoption of the rent regulation will result in higher interest costs. See e.g. *FREMONT, CAL., MUNI. CODE* § 9.55.160(c)(11)(A) (2021), <https://www.codepublishing.com/CA/Fremont/> (excluding mortgage interest except for increases in mortgage costs when associated with refinancing compelled by the terms of mortgage entered into prior to December 1, 1985).

126. In contrast, under rate of return on investment standards, owners who have been obtaining more than the minimum rate may not be able to obtain a rent increase to cover cost increases and provide for growth in net operating income above pre-regulation levels or levels of prior years if rate of return remains above the specified minimum. This outcome would be common for long term owners who have low investments relative to their current income.

127. See *Rainbow Disposal v. Mobilehome Park Rental Review Bd.*, 64 Cal. App. 4th 1159, 1172 (Cal. Ct. App. 1998) ("MNOI approach ... is a fairly constructed formula' which provided [the park owner] a sufficiently 'just and reasonable' return on its investment"); see also *Colony Cove v. City of Carson*, 220 Cal. App. 4th 840, 869-870 (Cal. Ct. App. 2013) (noting that the MNOI standard "permits park owners to obtain a just and reasonable return under general marketing conditions in any given year" and "reflect[s] the tenant's interest by giving the park owner an incentive to incur all reasonable expenses for maintenance and services." (quoting *Oceanside Mobilehome Park Owners' Ass'n v. City of Oceanside*, 157 Cal. App. 3d 887, 902-03 (Cal. Ct. App. 1984))).

128. *Colony Cove*, 220 Cal. App. 4th at 869 (quoting *H.N. & Frances C. Berger Found. v. City of Escondido*, 127 Cal. App. 4th 1, 9 (Cal. Ct. App. 2005)).

Under MNOI standards a year preceding the adoption of the rent regulation is usually specified as the base year, on the basis that the net operating income prior to the adoption of rent regulation reflected market conditions.¹²⁹ However, since Delaware has had rent regulations for eight years, an option of allowing owners to use a designated base year shortly preceding the adoption of an MNOI standard may be appropriate because some owners may not have income and expense records from 2013.¹³⁰ Since the Act has authorized full CPI increases since 2013, a reasonable, rebuttable presumption would be that the pre-rent regulation rent levels adjusted by the full increase in the CPI in the years prior to the designated base year provide a fair profit level.

For owners who charged very low rents in the base year, inflation adjusted levels of base year net operating income will remain low. In order to place owners with very low base year rents on equal footing under the MNOI standard, California courts have ruled that the base year rents which do not reflect market conditions must be adjusted upward to establish base year net operating income when calculating a fair net operating in the current year.¹³¹ The MNOI standards in California generally have a provision that allows for adjustment where base year rents are “disproportionately” low.¹³²

Currently, the MNOI standard is widely used in local California manufactured housing rent regulations.¹³³ California appellate courts have upheld the MNOI methodology, and repeatedly praised it as the most reasonable fair return standard.¹³⁴ The New Jersey Supreme Court has similarly commented favorably on its use.¹³⁵ Including this methodology in Delaware’s Rent Justification Act or in regulations adopted pursuant to the Act would be similarly following best practice.

129. See, e.g., SANTA CRUZ CNTY., CAL., CNTY. CODE § 13.32.040(B)(4) (2021).

130. The adoption of an MNOI standard could include notice that base year income and expense information would be required in fair return petitions. Commonly under the MNOI standards in California ordinances, if base year operating expense information is not available, the expense amounts for the base year may be estimated based on available information or rebuttable presumptions about the rates of increase in different types of expenses. See SAN JOSE, CAL., MUNI. CODE § 17.22.495; CITY OF YUCAIPA, CAL., ADMIN. RULES § 4.0003(F) (2022) (“Where scheduling of rental increases ... require projections of income and expenses because actual data is not available, it shall be presumed that operating expenses and management expenses ... increase at the rate of the increase in the CPI for the applicable year”).

131. *Vega v. City of West Hollywood*, 223 Cal. App. 3d 134 (Cal. Ct. App. 1990) (allowing upward adjustment to base year rent where elderly apartment building owner had not raised the rents in 20 years preceding the base year, which, without adjustment, would have resulted in exceptionally low fair net operating income in the current year even when adjusted for inflation.); see also *Concord Communities v. City of Concord*, 91 Cal. App. 4th 1407, 1417-18 (Cal. Ct. App. 2001) (applying principles in *Vega*); *Apartment Ass’n of Greater Los Angeles v. Santa Monica Rent Control Bd.*, 24 Cal. App. 4th 1730, 1737 (Cal. Ct. App. 1994) (finding “regulation which prohibits landlords who purchased rental property after the inception of rent control from seeking an adjustment to base rent” facially invalid, while recognizing there is “no general entitlement to an increase in base date rents predicated on market conditions”).

132. See, e.g., SAN JOSE, CAL., MUNI. CODE § 17.22.510 (2022) (providing other grounds for adjusting base year net operating income include extraordinarily low income and/or expenses in the base year).

133. See, e.g., RIVERSIDE CNTY., CAL., CNTY. CODE §§ 5.36.090(B), 5.36.250 (2022), https://library.municode.com/ca/riverside_county/codes/code_of_ordinances; SAN JOSE, CAL., MUNI. CODE § 17.22.550 (2022).

134. See *Colony Cove*, 220 Cal. App. 4th at 869-870, 844-845 (“By maintaining net operating income, adjusted upward for inflation, from year to year, this approach allows for appreciation and permits the purchaser to determine whether the property is worth the selling price based on the purchaser’s individual cash flow requirements and its future plans for the property.”); *Rainbow Disposal*, 64 Cal. App. 4th 1159, 1172 (Cal. Ct. App. 1998); *Palomar Mobilehome Park Ass’n v. Mobile Home Rent Review Comm’n.*, 16 Cal. App. 4th 481, 486 (Cal. Ct. App. 1993); *Baker v. City of Santa Monica*, 181 Cal. App. 3d 972, 975-76 (Cal. Ct. App. 1986); *Oceanside Mobilehome Park Owners’ Ass’n v. City of Oceanside*, 157 Cal. App. 3d 887 (Cal. Ct. App. 1984).

135. *Mayes*, 511 A.2d. at 589.

C. Establish Reasonable Criteria for the Treatment of Expenses

Questions about the proper treatment of expenses for the purpose of calculating an allowable rent have emerged in arbitration cases and will continue to surface. They are likely to take on a more important role if community owners are required to demonstrate that overall expenses have increased or that net operating income has decreased in order to meet the “directly related” standard and/or community owners cannot rely on a market rent standard. Up to now, differences among arbitrators and courts about how to treat expenses have led to enormously disparate outcomes.¹³⁶ It is not possible to draft guidelines that will anticipate and resolve every type of situation that will emerge. However, more detailed amendments to the law or regulations could resolve some of the issues that have recurred in arbitrations pursuant to the Act or have emerged in other states and are likely to emerge in future cases in Delaware.¹³⁷

1. Allowances for Capital Improvements and Other Expenses Which Are Not Annually Recurring

Under the existing Act, arbitrators have struggled to differentiate between capital improvements and operating expenses, and have acknowledged the difficulties of coming up with a precise or universally accepted definition.¹³⁸ For example, disputes have emerged over whether major system replacements that are not superior to the former system are capital improvements.¹³⁹ Other issues arise concerning rent increase allowances for operating expenses which are exceptional, rather than recurring, such as remediation of accidents, storm damage, or other disasters, major landscape overhauls, exceptional legal expenses, or one-time assessments.

The issue under a rent justification act should not be whether the cost can be classified as a capital improvement, but whether it is non-recurring and what methodology will provide a reasonable allowance for the cost.¹⁴⁰ If the cost is

136. See *December Corp. v. Wild Meadows Home Owners Ass’n*, 2016 WL 3866272, at *7 (Del. Super. July 12, 2016) (holding that an increase in the base rent is permanent even though “one time capital improvement charges are long since recovered”), *abrogated* by *Rehoboth Bay Homeowners’ Ass’n v. Hometown Rehoboth Bay*, 252 A.3d 434 (Del. May 13, 2021). In *December Corp.* the Superior Court acknowledged the problematic nature of this outcome, but concluded that it was bound by the “clear language of the statute” to authorize a permanent increase because the Act did not include a “one time cost recovery rider.” *Id.* A few years later, two arbitration decisions were upheld in Superior Court on the basis of *December Corp.* awarded permanent rent increases of approximately \$75 per month per lot for costs that would be recovered in one year. *Iacona v. Hometown Rehoboth Bay, LLC*, 2020 WL 4559459 (Del. Super. Aug. 6, 2020); *Rehoboth Bay Homeowners’ Ass’n v. Hometown Rehoboth Bay*, 2021 WL 1316831 (Del. Super. March 16, 2020). When the Delaware Supreme Court heard those cases in a consolidated appeal, it took a different view, holding:

Once the cost of a non-recurring capital improvement is recovered by the community owner in full through a rent increase, the continued assessment of that increase indefinitely becomes unrelated to the benefits and costs of living in the community. Under the Superior Court’s interpretation of § 7052 in *December Corp.* unreasonable and burdensome rent increases [were] inevitable.

Rehoboth Bay Homeowners’ Ass’n, 252 A.3d at 444. Notably, it took five years to overturn a rent adjustment methodology which was clearly inequitable and diametrically counter to the purposes of the Act.

137. For detailed guidelines regarding the treatment of expenses in manufactured housing community rent arbitration cases, see HUMBOLDT CNTY., CAL., CNTY. CODE § 9101-10 (2021).

138. See *Iacona & Weymouth v. Hometown Rehoboth Bay, LLC*, Dkts. 7 & 8, 2016, at 5-6 (DEHMRA March 6, 2017) (Young, Arb.); *Sunset of Affected Lots in Holly Hill Estates v. Holly Hill Estates*, Dkt. No. 6, 6 (DEHMRA Aug. 10, 2017) (Morton, Arb.).

139. *Iacona & Weymouth*, Dkts. 7 & 8, 2016, at 5-6.

140. See, e.g., VT. STAT. tit. 10, § 6251(b) (2022) (limiting a lot rent surcharge for the cost of capital improvements to the period “when the park owner has recovered the cost of the capital improvements”).

substantial and occurs only infrequently or is only one time, it should be amortized, with an interest allowance added into the cost.¹⁴¹ As a matter of constitutional law, when the cost of a capital improvement is amortized for the purposes of determining an allowable rent increase in order to compute the fair measure of the cost, an interest allowance is required.¹⁴² The interest allowance should be uniform in all cases, at a rate reflecting typical loans for purchases of income producing rental properties, rather than varying by the particular community owner. Otherwise, different owners would be entitled to vastly differing rent adjustments for comparable expenditures, depending on how they finance the cost and, by extension, the particular circumstances of the owner and the park.

Another issue is whether capital improvements which are replacements or upgrades of existing systems should be authorized as separate stand-alone passthroughs or should be considered in the context of what rent increases are required to provide a fair return, taking into account the overall income and operating expenses and income history of a community. If overall returns and increases in rents are not considered, communities with increases in income that have been well in excess of the CPI increase will be provided with the same increases for capital improvements regardless of whether their growth in net operating income has been adequate to cover these costs. Capital improvements which are replacements are normal in the ownership of rental properties and expected to be anticipated in setting the acquisition price for such properties.

2. Reasonability of Expenses

Subsection (C) provides that “changes in *reasonable* operating and maintenance expenses” may be a justification for a rent increase above the CPI increase, without any elaboration of the term “reasonable.”¹⁴³ This standard opens up a broad range of considerations for potential review, including whether the particular expenses are typical compared to other years, and/or in keeping with normal expense levels in the industry. Under the rent laws in other states, community owners are commonly required to submit several years of data so it can be determined whether particular types of operating expenses or expense levels are ongoing or are atypical and should be adjusted or amortized.¹⁴⁴ Also, some laws

141. In some instances, arbitrators have concluded that community owners may be entitled to rent increases to cover the costs of capital improvements which are uncompleted. *E.g.*, *Ruben v. Bon Ayre Land LLC*, Dkt. No. 17-598, at 3 (DEHMRA Sept. 22, 2017) (Kuhl, Arb.) (requiring completion “could prevent an owner from initiating any desired improvements if rent adjustments could not take place until the improvement is completed.”). It does not seem reasonable to require owners to pay for improvements before they start receiving the benefits of the improvements, just as it would not be reasonable to require homeowners to pay space rents for periods prior to the date when they could possibly occupy the community because its construction had not been completed. On the other hand, community owners should be provided with a right to find out in advance of a planned substantial expenditure what rent increase would be allowed if it is undertaken. One approach is to provide for a right to obtain an advance determination of the amount of a rent increase that would be granted when the proposed capital improvement is completed, thereby providing certainty and an ability to realize a recovery as soon as the improvement is completed. Some regulations “[i]n order to promote advance fiscal planning” provide “park owners ... the option of precertifying capital improvements ... in advance of performing the work” to determine if the costs can be passed on to the effected residents pro rata. *FREMONT, CAL., MUNI. CODE § 9.55.07(a)* (2021).

142. *Sierra Lake Reserve v City of Rocklin*, 938 F.2d 951, 958 (9th Cir. 1991) (“To the extent plaintiff alleges that the rent increases allowed on account of capital improvements merely offset the cost of those improvements (or less), it has stated a claim for a violation of substantive due process.”); *see Morgan v. City of Chino*, 115 Cal. App. 4th 1192, 1199-1200 (Cal. Ct. App. 2004) (citing cases and holding that an owner does not have a right to an increase for a capital improvement cost independent of consideration of overall income and expenses in order to determine what increase is necessary in order to permit a fair return).

143. 25 DEL. C. § 7052(c)(5) (2022) (emphasis added). The Delaware Supreme Court has indicated that the statutory requirements in order to justify a rent increase are “modest.” *Bon Ayre II*, 149 A.3d 227, 235 (Del. 2016). When considering what requirements may be “modest” relative to the stakes in a rent adjudication, one perspective is that a \$25/space/month rent increase in a community with 100 spaces will add \$30,000/year to annual rental income and about \$500,000 to the market value of the community.

144. *See, e.g.*, 31 R.I. GEN. LAWS § 31-44.1-2(c) (2022); *HUMBOLDT CNTY., CAL., CNTY. CODE, § 9101-11(c)(3)(D)* (2021); *BELCHERTOWN, MASS., MUNI. CODE § 235-9.(A)(1)* (2021), <https://ecode360.com/BE1703> (three years of income and operating expense data required).

specifically provide that industry norms shall be taken into consideration.¹⁴⁵ Consideration of these factors is essential to insuring reasonable outcomes.

3. Treatment of Debt Service

The Subsection (C) factors include “changes in ... financing associated with the manufactured home community.”¹⁴⁶ Up to now, debt service has not been considered as a factor in the arbitration decisions, unless it was associated with the financing of capital improvements.¹⁴⁷ However, in future cases, new purchasers may raise claims based on their mortgage financing.

When determining allowable rents, financing costs should be seen as a cost of capital used to purchase a manufactured housing community or, in the case of refinancing, as a source of funds using a community as collateral. Otherwise, if community owners can charge their tenants for their purchase mortgage interest payments, then the homeowners are bound to fund the community owner’s investment in the land, as well as providing a fair net operating income that will cover the mortgage payments associated with the investment.¹⁴⁸

While repeatedly holding that the formulation of a fair return standard is a legislative task,¹⁴⁹ appellate courts in Massachusetts, New Jersey, and California have concluded that it is not appropriate to take into account debt service when determining allowable rents under rent regulation.¹⁵⁰ The reasonable approach is to exclude debt service for purchase

145. *E.g.*, EL MONTE, CAL., MUNI. CODE § 8.70.080(E)(3)(c)(iv) & (v) (2021), https://library.municode.com/ca/el_monte/codes/code_of_ordinances (expenses exceeding the normal industry standard must be shown to be reasonable, and base year expenses which are exceptionally low by industry standards may be adjusted upwards).

146. 25 DEL C. § 7052 (c)(4).

147. *See, e.g.*, Wild Meadows Homeowners Ass’n v. Wild Meadows MHC, LLC, Dkt. No. 10-2017, at 17 (DEMhRA, Jan. 21, 2019) (Gibbs, Arb.) (finding that “acquisition costs and debt service, which relate to the community owner’s underlying investment in the community itself” cannot be tied to how return is computed for purposes of meeting the directly related requirement).

148. Under standard mortgage lending criteria net operating income must be adequate to cover mortgage debt service. *See* Mike E. Miles et al., REAL ESTATE DEVELOPMENT 219 (2015) (“[L]enders generally require a DSCR [Debt Service Coverage Ratio] between 1.20 and 1.60.”).

149. *See supra* note 108 and accompanying text.

150. *See* Zussman v. Rent Control Bd. of Brookline, 359 N.E.2d 29, 34 (Mass. 1976) (holding that “a landlord’s decision to minimize or wholly eliminate his initial capital outlay cannot justify imposing higher rents on his tenants. Nor does it warrant permitting him to collect higher rents than other less heavily financed landlords.”); Helmsley v. Borough of Fort Lee, 394 A.2d 65, 80-81 (N.J. 1978) (“Discrimination based upon the age of mortgages serves no legitimate governmental purpose.”); Palomar Mobile Home Park Ass’n v. Mobile Home Rent Review Comm’n, 16 Cal. App. 4th 481, 488 (Cal. Ct. App. 1993) (“Palomar’s version of the ‘historic cost’ formula means that an owner’s fair return will vary depending on the financing arrangements.... We see no reason why this should be the case.”); Colony Cove Properties, LLC v. City of Carson, 220 Cal. App. 4th 840, 870-871 (Cal. Ct. App. 2013) (“Apart from the inequities that would result from permitting a party who financed its purchase of rent-controlled property to obtain higher rents than a party who paid all cash, there are additional reasons for disregarding debt service.... [D]ebt service arrangements could easily be manipulated.”). *But see* Palacio de Anza v. Palm Springs Rent Review Comm’n, 209 Cal. App. 3d 116, 120 (Cal. Ct. App. 1989) (holding that community owners have a vested right to have their debt service considered if debt service was listed as an expense for the purpose of calculating net operating income when the property was purchased); El Dorado Palm Springs, Ltd. v. Rent Review Comm’n, 230 Cal. App. 3d 335, 343 (Cal. Ct. App. 1991) (holding same). The Palm Springs ordinance, however, was distinguishable from the Delaware statute and most other California ordinances because at the time it specifically included mortgage payments as an allowable expense in the calculation of net operating income.

financing in setting allowable rents, while at the same time providing for a uniform interest allowance for the recovery of operating costs and capital improvements which are amortized.¹⁵¹

D. The Effective Date of Proposed Rent Increases

Currently, manufactured homeowners must begin paying rent increases in excess of the CPI increase as soon as they are proposed, rather than waiting for a determination as to their validity in arbitration.¹⁵² Under California ordinances proposed increases cannot be implemented until they are approved or unopposed.¹⁵³ If substantial rent increases can be imposed prior to a determination of whether they are permissible, homeowners may be pressured into reaching settlements because they cannot afford an increased rent level, even though the increase may not have been justified under the Act. To avoid unnecessary hardship on the lessees while also making landlords whole, the California Supreme Court ruled that allowable rent increases include a right to retroactive rent charges to cover the period when the rent increase should have been permitted.¹⁵⁴

V. CONCLUSION

The Rent Justification Act remains mired in uncertainty concerning the conditions for obtaining rent increases and the standards for setting allowable increases. Outcomes vary wildly at the arbitration, Superior Court, and Supreme Court levels. The following amendments to the Act are critical to its operation in a consistent, predictable, and workable manner that will fulfill its purposes:

1. Clarifying what evidence is required to meet the “directly related” standard;
2. Linking the amounts of allowable rent increases above the CPI increase to the amount of specific expense increases, an increase in overall expenses, and/or to the amount necessary to provide a fair return;
3. Requiring that all of the factors in Subsection C be taken into account in determining what rent increase is allowable, in order to provide outcomes consistent with the overall purposes of the Act;
4. Replacing the “market rent” standard in the Subsection C factors with a “just, reasonable, and fair return” factor; and
5. Setting forth a specific methodology for calculating a “just, reasonable, and fair return.”

151. See, e.g., EL MONTE, CAL., MUNI. CODE §8.70.080(E)(3)(a)(ix) (2021) (providing that the interest allowance for expenses that are amortized are tied to a particular published average interest rate on single family mortgages plus two percent).

152. 25 DEL. C. § 7053(l) (2022).

153. See, e.g., SAN BERNARDINO, CAL., MUNI. CODE § 8.90.290 (2022), https://sbcity.org/residents/municipal_code.asp; SAN JOSE, CAL., MUNI. CODE § 17.22.617(E) (2022); but see, e.g., VT. STAT. tit. 10, § 6253(b) & (e) (2022) (requiring proposed rent increases to be paid into the court pending resolution).

154. *Kavanau v. Santa Monica Rent Board*, 16 Cal. 4th 766, 783-784 (1997). In *Kavanau*, the full rent increase was denied at the initial adjudicatory level, but was granted pursuant to an appeal, after a substantial lapse of time. *Id.* at 767. In cases where the adjustment is large, some rent boards have provided for the recovery on an amortized basis with an interest allowance from the date of the original adjudication through the end of the amortized recovery period. See, e.g., Yucaipa Rent Review Commission, Resolution No. 2008-29 ¶ 29 (June 26, 2008) (on file with author). This type of rent adjustment is now known as a “Kavanau adjustment.” *Galland v. City of Clovis*, 24 Cal. 4th 1003, 1008 (2001).

A fair and workable balance between community owners and homeowners depends on a predictable system that allows community owners to obtain a fair return while protecting manufactured homeowners from rent increases that are not justified by increases in their costs of operating communities and inflation.

ADDENDUM

This addendum briefly describes and comments on critical aspects of the amendments to the Act which went into effect on July 1, 2022.¹⁵⁵

Starting out the gate, it should be noted that the amended law is extremely difficult to decipher. New sections which are now in effect but sunset in five years and other new sections which do not sunset are interspersed among sections that are now suspended for five years. The amendments are heavily populated with cross-references, which must be navigated in order to comprehend them. The outcome is a maze, rather than a readily comprehensible Act.¹⁵⁶

In substantive terms, the 2022 amendments include a 3.5% floor on the annual increases authorized pursuant to the CPI standard.¹⁵⁷ The amendments provide that operating cost information used to justify rent increase claims is public record.¹⁵⁸ Also, the amendments rectify some of the previous uncertainties in the law. For five years, the law suspends the requirement that community owners demonstrate that their proposed increases in excess of CPI meet the vague “directly related” standard, which led to rounds of dispute and litigation at the arbitration, superior court and supreme court level.¹⁵⁹ The amendments also include a specific formula for calculating the amount of allowable rent increases above CPI if they are justified by operating cost increases.¹⁶⁰ In contrast, the suspended portions of the Act listed types of relevant expenses but did not provide any direction in regards to how the increases in their costs should be weighed.¹⁶¹

On the other hand, other amendments undercut the purposes of the Act. The amendments embed as a standard the rents agreed to by incoming mobile home purchasers as an allowable rent for all the manufactured homeowners in a community. Another amendment, which is in effect for five years, provides that leases that are more than one year are exempt from any rent regulation.

A. “Market Rent” Embedded as a Stand-Alone Measure of Allowable Rent

Under the earlier act, “market rent” was one of a list of factors that “may” justify a rent increase above the CPI increase.¹⁶² Under the amended Act, which is in effect for five years, community owners may increase rent based on the

155. 83 Del. Laws 341 § 11 (June 30, 2022).

156. *Id.* §§ 3, 4; *see also infra* text accompanying note 182 (describing the complexities of the rental assistance standard).

157. *Id.* § 4 (adding 25 DEL. C. § 7052A(c)(2)(a)). Note that it is unclear whether the rate of increase may fall below 3.5% if the CPI falls below zero.

158. *Id.* (adding 25 DEL. C. § 7052B(a)(1)).

159. *See id.* § 3 (amending 25 DEL. C. § 7052(a)); *see also supra* text accompanying notes 46–75.

160. *Id.* § 4 (adding 25 DEL. C. § 7052B). Under the formula, the allowable increase is equal to the amount by which the aggregate of increases in specified operating expenses (taxes, insurance, utility charges, employment benefits and employment taxes) has exceeded the percentage increase in the CPI. *Id.*

161. *See* 25 DEL. C. § 7052(d) (2022).

162. 25 DEL. C. § 7052(c)(7) (2022).

“market rent” standard without having to meet the “directly related” standard.¹⁶³ The amended law effectively establishes a stand-alone right to such increases, subject only to the qualification of compliance with health and safety standards, assuming the tenant does not qualify for the “rental assistance” provisions.¹⁶⁴

Notably, the amendments include other provisions that moderate the impact of the “market rent” standard. They provide that increases justified by this benchmark must be phased in over seven years, if they are not more than fifty percent of the current rent, and over a ten year period, if they are a higher percentage of the current rent.¹⁶⁵ Also, they provide that CPI rent adjustments cannot be imposed in the same year as market rent adjustments.¹⁶⁶ If inflation rates are high the rent increases authorized under the market standard may not be much above the amounts authorized under the CPI standard, or may even be lower. Conversely, they may be substantially higher than CPI-based standards during periods of low inflation. The “rental assistance” provisions for qualifying low- and moderate-income households are another moderating factor that may or may not have a substantial impact.¹⁶⁷

Among the manufactured housing community rent legislation in the United States, Delaware remains apart in providing that the rents agreed to by new tenants in a community and comparable communities are the measure of allowable rents for all the tenants in the community, rather than only new tenants who have agreed to the new market rent levels. Apart from the conceptual issues associated with the “market rent” standard,¹⁶⁸ on a practical level the standard will generate unequal contests in disputes about the actual level of market rents and games of manipulation.¹⁶⁹

The bottom line is that the “market rent” standard turns tenancy in manufactured housing communities and investments in purchasing manufactured homes into a speculative and risky venture by vitiating certainty that rent increases will be proportionate to increases in the CPI or, if above the CPI, limited to the amounts that may be justified by increases in the community owners operating costs and costs of capital improvements.

B. The Lease Exemption

Under the amendments to the Act, rental agreements that are entered into within the next five years which are over a year in duration are exempt from its rent increase regulations.¹⁷⁰ California adopted this type of exemption in 1985, but then modified its law in 2020 to withdraw the exemption from rental agreements entered into after February of that

163. See 83 Del. Laws 341 § 4 (adding 25 DEL. C. § 7052A(b)(1)(b)).

164. See *id.* §§ 4, 7.

165. See *id.* (adding 25 DEL. C. § 7052A(d)(3)).

166. See *id.* (adding 25 DEL. C. § 7052A(b)(1)).

167. See *infra* at text accompanying notes 176–181.

168. See *supra* at text accompanying notes 76–95.

169. Potential manipulations in the rent setting process for incoming homeowners include offering community owned homes at low prices in order to obtain agreements to higher initial rents or setting initial rents at a higher level in return for lower increases in future years. On a practical level an arbitration over the level of the market rent level pits community owners who can easily find appraisers who specialize in manufactured housing community transactions against homeowners who have to find an appraiser who both has knowledge about manufactured community space rents and is willing to testify against the interests of their primary economic source, the real estate industry. In California, in cases which rent data from comparable manufactured housing communities is considered in order to determine whether the average rent in a community was disproportionately low in either a base year or the current year, cities commonly employ another appraiser to provide an independent review of the appraisal submitted by the community owner.

170. See 83 Del. Laws 341 § 1 (adding 25 DEL. C. §§ 7052A(b)(1)(c)).

year.¹⁷¹ Before withdrawing the exemption altogether, the state adopted several laws in attempts to curb its abuses, such as requiring that community owners notify homeowners of their right to have thirty days to inspect the agreement, providing a right of rescission within 72 hours of signing an exempt agreement, and requiring a notice that homeowners must be offered a rent controlled lease on the same essential terms.¹⁷²

In opposition to claims that the lease exemption was detrimental to the interests of homeowners, California community owner representatives maintained that homeowners only enter into such agreements because they perceive some benefit that outweighs the benefits of rent control.¹⁷³ However, homeowner representatives explained that:

[T]he protections in existing law do little to overcome the fundamental asymmetry at the heart of this bargaining relationship. In contrast to most mobilehome residents, park owners are constant and repeat players in mobilehome lease negotiations, they are versed in mobilehome law, and they often have ready access to sophisticated legal counsel.¹⁷⁴

One city council letter explained that the exemption was completely undermining the rent regulations:

[T]he state law exempting long-term leases has allowed for abuses that render ineffective the City's mobile home rent stabilization program... Not surprisingly, most residents of mobilehome parks do not have the resources to sue Park owners that have inappropriately maneuvered them into long-term leases... The long-term lease exemption is serving to completely undermine the City's rent stabilization regulations and damage the affordability of its housing stock.¹⁷⁵

C. The “Rental Assistance” Provisions

Under the amendments, the existing Lot Rental Assistance program, which places limits on allowable rents based on household income, has been modified in part and expanded in part. These restrictions are categorized as “rental assistance,” but they refer to restrictions on the allowable rent, rather than public assistance.¹⁷⁶ Eligibility for the assistance is limited to homeowners who, among other things, have resided in a community for five or more years and have liquid assets under \$50,000.¹⁷⁷ These rights cannot be transferred to new owners.¹⁷⁸

171. CAL. CIV. CODE § 798.17(i)-(j) (2021).

172. Senate Judiciary Bill Analysis, SB-999, 2019-2020 Reg. Sess. at 3 (Cal. 2020), *available at* https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201920200SB999 (providing history of earlier efforts to amend Section 798.17 and setting forth the rationale for and against withdrawing the exemption.).

173. *See id.*

174. *Id.*

175. Letter from Carpinteria City Council Members to Sen. Tom Umberg, Cal. Senate (Feb. 24, 2020) (on file with author).

176. *See* 83 Del. Laws 341 § 7 (amending 25 DEL. C. § 7022).

177. *See id.* (amending 25 DEL. C. § 7022(a)). Previously, the existing program placed a limit on eligibility for homeowners who owned their homes as of a date certain, July 1, 2006, rather than a set period of time. *See* 75 Del. Laws 382 § 7 (2006).

178. *See* 83 Del. Laws 341 § 7 (amending 25 DEL. C. § 7022(a) and adding § 7022B(c)).

The existing “rental assistance,” with its updated eligibility requirements, includes a ceiling on lot rents of thirty percent of the income of homeowners with a household income below forty percent of the median.¹⁷⁹ This ceiling might seem to parallel the standard limit which is generally applicable in subsidized housing, where rents plus utility costs are typically limited to thirty to thirty-five percent of income.¹⁸⁰ However, unlike apartment owners, manufactured housing community owners do not provide housing structures. Instead, the costs of acquiring and maintaining the dwelling are an additional cost above the lot rent, rather than a cost included in the thirty percent ceiling. Also, utilities are usually an additional cost above the lot rent. Thus, the thirty percent cap on the lot rent to income ratio only takes into account one portion of the housing costs, leaving out central components of the real cost.

The new addition to the Lot Rental Assistance program in the amendments introduces a unique type of standard which is applicable to households which have an income ranging from forty to fifty-five percent of the county median. The law contains a sliding scale of the percentage of allowable rent increases that may be imposed on tenants in this income range, as opposed to a ceiling on the rent to income ratio.¹⁸¹

Apart from being unique in concept, the standard is incredibly complex. The percentage reduction below the otherwise allowable rent increase depends on the ratio of the household income to the published median household income in the particular year. The amounts of the reductions are based on a formula in which household income/median income ratio categories are divided into seven two-percent increments and accompanied by seven differing ratios of the portion of otherwise allowable rent increases that may be imposed.¹⁸² Consequently, within a community there may be eight different answers about the allowable percentage rent increase in any particular year: seven for the “assisted” homeowners within an income ranging from forty to fifty-five percent of the median, and another for the “unassisted” homeowners.

Outside of Delaware the underlying paradigm of rent regulation has been to limit rent increases to reasonable levels, rather than to tie allowable increases to individual household income levels. Apart from this observation, consideration from a legal and practical perspective of how these “rental assistance” provisions will turn out is beyond the scope of this addendum.

D. Informing the Public and Lawmakers About the Outcomes Under the New Law

The Act requires that copies of notices of all rent increases must be provided to DEMHRA.¹⁸³ It would be invaluable to require that the notices include additional information, including (a) the standard under which each rent was set (e.g. CPI, market rent, exempt lease, increases subject to limitations set by the rental assistance provisions) and (b) the types of utility costs that are passed through, apart from the lot rent, and the amounts of those passthroughs. This information should be collected in a database used to prepare public reports on overall rent levels, the amounts of rent increases,

179. *See id.* (amending 25 DEL. C. §7022(d)).

180. *See, e.g., Services for Renters*, DELAWARE STATE HOUSING AUTHORITY, http://www.destatehousing.com/Renters/rt_s8hcv.php (last visited August 3, 2022) (noting cap on rent and utility payments of thirty to thirty-five percent of income in Section 8 housing program).

181. *See id.* (adding 25 DEL. C. § 7022B(d)).

182. *Id.* (allowing rent increase of *e.g.* 24.25% if “the median household income is greater than 40% and below 42%”, or 38.5% if “median household income is equal to or greater than 42% and below 44%....”).

183. *See id.* § 2 (amending 25 DEL. C. § 7051(c)(1)).

the bases for the increases, and the outcomes under the “rental assistance” requirements.¹⁸⁴ This step would provide the public and lawmakers with substantial information (as opposed to anecdotes) about how a law that determines the rents of 20,000 households is actually working and on the actual impacts of each of the rent increase mechanisms in the law.

E. Summary

The purpose of manufactured housing community rent regulations is to protect the security and investments of manufactured homeowners. Tying allowable rent increases to increases in the CPI, with greater increases permitted when needed in order to obtain a “fair return” or cover operating cost increases is a reasonable and standard approach for accomplishing this objective. Instead, under the revised Act, the rents agreed to by incoming tenants in a subject community and comparable communities are a determinant of allowable rents for the other homeowners in a community, and rent levels set in leases of one year or more are exempt from regulation. These avenues incorporate, rather than correct, the imbalances in market conditions that spur the adoption of regulations of rent increases in manufactured housing communities.

184 . Publicly available data and reports could be limited to aggregate data when necessary to protect confidential information about individual homeowners.

