Real Property Section Review

Los Angeles County Bar Association

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Current Issues in Surety Law — An Overview

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By: Randal J.A. Ivor-Smith, Esq.

The Real Property Section of the Los Angeles County Bar Association recently held a seminar entitled "Current Issues In Surety Law," co-hosted by Carlo Paciulli, Esq., an associate at Hunt Ortmann Blasco Palffy & Rossell, Inc., and Jonathan Dunn, Esq., a partner at Sedgwick Detert Moran & Arnold LLP. This article, based on the presentations by Mr. Paciulli and Mr. Dunn, presents a brief overview of some of the major issues facing contractors with respect to surety.

Mr. Paciulli's presentation focused on current difficulties associated with obtaining surety coverage, an alternative to surety that is available to contractors, and the possibility of unintended waiver and release of bond claims through the receipt of progress payments. Mr. Dunn's presentation focused on two trends in surety law: a legal trend signified by an eroding line of liability between sureties, on the one hand, and

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Elements of a Real Estate Loan – A Primer

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By: Henry A. Herrman, Esq.[1] and Randal J. A. Ivor-Smith, Esq.[2]

The Real Property Section of the Los Angeles County Bar Association recently sponsored a presentation entitled "The Elements of a Real Estate Loan," given on February 2, 2005, by Robert E. Williams, Esq., a partner at Sheppard Mullin Richter & Hampton LLP. Mr. Williams presented a summary introduction of commercial lending from the lenders' perspective. In his presentation, Mr. Williams discussed the benefits lenders receive from good loans, and the burdens lenders attempt to avoid from bad loans. The presentation included comments on the predominate remedies available to lenders when faced with pending or actual loan defaults, and how the foregoing shapes the structure, terms and conditions of commercial loan documents. This article, based upon Mr. Williams' comments, presents a brief primer on some of the major considerations for commercial real estate lenders in their lending business.

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Current Issues in Surety Law — An Overview

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principals or bonded contractors, on the other; and a factual trend toward public contracts that are unsecured by surety bonds.

I. Current Difficulties in Obtaining Surety Coverage

Most public work contracts in excess of certain dollar limits require a performance bond, which benefits the owner if the prime contractor defaults. The performance bond surety's obligation is triggered upon the default of the prime contractor. The performance bond allows the owner to look to the performance bond surety to step into the contractor's shoes and complete the contract.

Over the last ten years, there has been much consolidation of the surety industry, resulting in fewer surety options available to contractors. Additionally, as a result of some very large losses suffered by surety companies in the last ten years, the executives of surety companies have made it more difficult to obtain surety coverage. One method of lowering the risk to surety companies and increasing the difficulty in obtaining a bond has been to tighten the ratios for performance bonds from a previously typical 5% ratio, to a currently more typical 10% ratio. These two factors have resulted in contractors having less options available to them for surety coverage.

What alternative is then available to contractors who require a performance bond, but are unable to obtain one through a surety company?

II. Default Insurance — The Alternative to Surety Coverage

Default insurance works much like a surety bond, such that the general contractor pays a premium to the insurance company and the insurance company takes over the contractor's obligations upon default by the contractor. Default insurance is offered primarily by two companies: Zurich and AIG.

However, default insurance is also slightly different from a surety bond. With a surety bond, the surety does not anticipate a loss. With default insurance, on the other hand, the insurer anticipates absorbing a loss and thus, requires the payment of premiums, creating the added cost associated with default insurance. While the cost of obtaining a surety bond is substantially less than the cost of obtaining default insurance, the principal who obtains a surety bond must generally sign away "the kitchen sink" under a general indemnity agreement ("GIA"). When there are shareholders, they too must sign the GIA. Default insurance, on the other hand, does not require a GIA.

As for subcontractors, if they are insured, there is no direct personal liability for default because there is no GIA in play. However, if the subcontractor provides a performance bond, it will be subject to the GIA.

The GIA in a surety bond generally requires the general contractor to put money in trust for the subcontractors. When a subcontractor defaults, the general contractor who is the obligee under the performance bond must tender the claim to the surety. The surety then conducts a good faith investigation of the matter. If the principal improperly defaulted, the surety is not obligated to perform. While the surety may perform under such circumstances, it may do so under a reservation of rights.

With default insurance, on the other hand, there is no tender to a surety involved. With insurance, the contractor can direct the type and timing of the response, instead of waiting for the surety. While default insurance can involve a high deductible of Self-Insured Retention ("SIR"), good experience with the insurer can reduce the premiums or lead to a smaller SIR. Insurers may also seek subrogation of claims. The insurance can often cover resulting litigation and counter-claims, which bonds do not cover. Finally, under an insurance agreement, there are many provisions, such as the requirements for timely notice to the insurer, that must be satisfied. These provisions make it important for the contractor to understand the insurance policy to fully comply with its requirements.

III. Waiver and Release of Bond Claims Under the *Tesco* Decision

Under the recent case of *Tesco Controls, Inc. v. Monterey Mechanical Company* (2004) 124 Cal. App. 4th 780, contractors, subcontractors and material men are at risk of waiving bond claims (or mechanic's liens or stop notices) when they sign a conditional or unconditional waiver and release for a stated time period in exchange for a progress payment, unless they specifically reserve their rights to any prior claims. In *Tesco*, an unpaid subcontractor gave the general contractor a statutory conditional lien waiver and release conditioned upon payment of $50,000.00.

The court held that under Civil Code § 3262, the subcontractor had thereby waived mechanic's lien rights, bond rights, and stop notice rights for services rendered and materials provided up to the date stated on the release, even if those services and materials were not compensated by the progress payment. *Id.* at 797. The subcontractor was not precluded from pursuing mechanic's lien rights, bond rights, or stop notice rights for services rendered and materials provided after the date stated on the waiver and release.

Tesco emphasizes to contractors, subcontractors and material men the importance of reserving rights on both conditional and unconditional waivers and releases upon progress payment.

IV. The Eroding Line of Liability Between Sureties and Principals

In the past, a surety could rest on the four corners of its bond and be confident in a strict construction of the bond terms in its favor by the courts. However, a California and nationwide trend is changing that trend.

The erosion began with the case of *Washington International Ins. Co. v. Superior Court* (G.K. Backlund, Inc.) (1998) 62 Cal. App. 4th 981. In *Washington International*, a subcontractor on a public contract filed suit against the surety and others, seeking to recover on a payment bond after the contractor failed to make

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The Review and various programs sponsored by the Real Property Section are designed to provide accurate and authoritative information on real property issues. This information is made available with the understanding that the Section is not providing legal or other professional services. If legal advice or expert assistance is required on a real estate matter, the services of a competent professional should be retained.

progress payments. The Superior Court denied the surety's motion to strike portions of the first amended complaint regarding an "interest penalty." The surety then filed a petition for writ of mandate. The Court of Appeal held that the surety was required to pay the subcontractor a statutory interest penalty for the contractor's failure to make timely payments on the subcontract. The court's holding was based on Civil Code § 2809, which states that a surety's obligation is commensurate with the principal's obligation. The following language from Civil Code § 2809 is intended to limit the surety's obligation to the bond terms:

> The obligation of a surety must be neither larger in amount nor in other respects more burdensome than that of the principal; and if in its terms it exceeds it, it is reducible in proportion to the principal obligation.

The court in *Washington International* held that while:

> [i]t is true that a surety on an official bond undertakes no liability for anything which is not within the letter of the surety contract… it is equally true that where a surety bond is given pursuant to the requirements of a particular statute, the statutory provisions are incorporated into the bond, and that this is true whether or not the bond makes specific reference to the statute pursuant to whose requirements it is given, so long as it appears from all the circumstances that it was given pursuant to such statute.

Id. at 987. Thus, despite the lack of language in the surety agreement regarding statutory interest penalties or payment of attorneys' fees, the surety was held to be liable for the interest penalty and attorneys' fees.

The case of *Cates v. Talbot* (1999) 21 Cal.4th 28, took things even further through the use of the "incorporation doctrine." There, the court found the surety liable for delay damages that were not mentioned in the surety bond, but that were incorporated into the surety bond by way of the construction contract that contained a delay damages clause. "Although the bond did not explicitly mention the subject of delay damages," since the surety bond "referred to the contract" and the construction contract had "been made a part of the bond," the term in the construction contract regarding delay damages was incorporated into the surety bond. *Cates*, 21 Cal. 4th at 41 (internal quotations omitted).

In *National Tech Systems v. Superior Court* (2002) 97 Cal. App. 4th 415, the incorporation doctrine was taken even further. In that case, the subcontractor was suing the general contractor on a Stop Notice Release Bond. Although neither the bond nor the stop notice statute permitted attorneys' fees, because the subcontract had an attorneys' fees provision, the court held the surety liable for the subcontractor's attorneys' fees. The court stated that although "the bond does not specifically provide for the surety's liability for attorney fees," the subcontractor "may recover from the surety on the stop notice release bond the attorneys fees provided for in its subcontract, provided the total recovery does not exceed the amount of the bond." *National Tech Systems*, 97 Cal. App. 4th at 425-26.

V. The Issue of Public Contracts Without Bonds

Another trend affecting the surety industry is a factual issue: more and more often, public contracts are being performed without bonds. For example, although the Miller Act requires bonds for federal government public works, much of the work is unbonded, despite the requirement. As a result, there are large numbers of subcontractors who incur substantial damages when the general contractor goes "belly-up."

Similarly in California, under Civil Code § 3247, all school and local public works in excess of $25,000 require bonds. However, for reasons unclear, much of the work on such projects is actually unbonded. For example, in *Electrical Electronic Control, Inc. v. LAUSD* (2005) 126 Cal. App. 4th 601, the general contractor went bankrupt, thereby damaging the subcontractors and suppliers who did not get paid. The court allowed a subcontractor's negligence claim against the school district for failing to get a bond from the prime contractor. The court rejected the school district's argument that a subsequent bond covering the replacement general contractor also covered the prior unbonded contractor's obligations.

A similar result was reached in *N.V. Heathorn, Inc. v. Cou. San Mateo* (2005) 126 Cal. App. 4th 1526, in which the court allowed the subcontractor's negligence claim against the public owner who had neglected to get a bond from the prime contractor. The court rejected the owner's argument that the Tort Claims Act did not protect against this type of injury. The court held that the failure to obtain the bond as required under Civil Code § 3247 qualified as an "injury" supporting a cause of action under Government Code § 815.6, which states:

> [w]here a public entity is under a mandatory duty imposed by an enactment that is designed to protect against the risk of a particular kind of injury, the public entity is liable for an injury of that kind proximately caused by its failure to discharge the duty unless the public entity establishes that it exercised reasonable diligence to discharge the duty.

Finally, in *Walt Rankin & Assoc. v. City of Murietta* (2000) 84 Cal. App. 4th 605, the court held that public owners not only have a duty to require a payment bond executed by an admitted surety, but also that the public entity has a duty to exercise reasonable diligence to investigate the sufficiency of the surety that provided the bond. The court held the city liable for breaching that duty when the surety, that was a foreign corporation not licensed as a surety in California or any other state, and not authorized to do business in California, did not respond to the subcontractor's demand on the bond after the general contractor's failure to make payments owed the subcontractor.

VI. Conclusion

Surety bonds are more difficult to obtain than in the past. Default insurance is an alternative to surety bonds that, although more costly, gives the contractor more control over post-default actions taken and generally does not require the contractor to sign a general indemnity agreement. Contractors who sign a waiver and release of surety bond claims in exchange for a progress payment should be careful to explicitly reserve their claims and rights, or risk losing those claims and rights forever per the waiver and release. Finally, two clear trends in surety involve a legal blurring of the line of liability between a surety and the principal, and a factual trend of public works being performed without the required bonds in place.

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Elements of a Real Estate Loan – A Primer

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I. The Upside for Lenders with Good Loans.

Lenders make money by earning interest and fees on loaned funds. Lenders seek to receive repayment of principal, payment of interest on its outstanding principal, and fees for the underwriting, processing and funding of loans. Money, however, is a commodity much like any other commodity. Lenders must obtain their supply at a wholesale price, from various sources, including, for example, the Federal Reserve Bank, short and long term depositors, investors, and other lenders. Lenders then "sell" or lend, their supply of money to third parties at a retail price, i.e., a higher interest rate that they are paying for their source of funds. The spread of the retail interest rates over the wholesale interest rates, i.e., the lender's "cost of funds," represents the gross return or yield earned on funds lent. Other costs associated with lending the funds, including underwriting and processing costs, labor, materials, plants and equipment, to the extent not offset with fees paid by borrowers, all reduce lenders' profits and ultimate net operating income. The yield on loan funds constitutes substantially all of lenders' benefits from even the best of loans. In exchange for the foregoing returns, lenders must accept substantial risk of loss resulting from "bad loans" or loans that ultimately perform in some manner other than planned by the terms of the loan agreement entered into between lender and borrower.

II. The Downside for Lenders with Bad Loans.

When borrowers default and loans "go bad," i.e., when borrowers fail to repay principal and/or interest in a timely manner as agreed in the loan documents, lenders face the possible loss of not only their earned income, but the loss of the principal commodity on which they rely to earn returns in the future. Lenders need capital to funds loans, which is generally obtained from a variety of capital sources, all of whom supply capital to lenders on a temporary basis; capital providers expect lenders to repay capital funds sold to lenders, which lenders then resell to borrowers. Thus, when borrowers default on their loans, lenders not only lose interest yield on principal loan funds, but also face the prospect of repaying their capital source with funds that otherwise should have been lent to other borrowers.

When lenders exercise their rights under security agreements to foreclose on collateral, lenders are subjected to a host of unwanted ownership related risks, such as hazardous waste liability exposure, and "lender liability" risks on theories of tort and breach of contract (including where lenders intervene on behalf of borrowers for the purpose of controlling property operations, application of insurance proceeds, etc.). Moreover, federally insured lenders who experience defaulting loans, or loans otherwise exhibiting signs of payment default risk, may find themselves subjected to increased reserve requirements imposed by bank regulators, requiring such lenders to reserve, or set aside, extra capital to cover losses which have not yet occurred but which appear likely based upon the perceived risk (perceived by examiners) of default—loans may be forcibly classified as "bad" loans even before cure periods or reinstatement rights have run, which increases reserve requirements and further diminishes the return on total capital.

III. Lenders' Remedies for Loan Defaults.

Loan defaults break down into two major categories: monetary defaults and non-monetary defaults. Loan documents provide numerous remedies for lenders upon the occurrence of a default, but the most powerful remedy is foreclosure on the borrower's collateral. In California, however, under the "one form of action" rule (Cal. Code Civ. Proc. Section 726(a)), when a lender elects to foreclose through the power of sale under a deed of trust, the ability to commence a separate action for any deficiency on the promissory note is waived. Alternatively, lenders can forego their power of sale, and elect to pursue judicial foreclosure, and, in certain circumstances, a deficiency judgment. But where lenders commence an action on the note, disregarding their security, borrowers can by affirmative defense under California's "security first" rule, *see id.,* force the plaintiff lender to pursue the collateral first through judicial foreclosure. Judicial foreclosures, however, are painfully slow and subject to long redemption periods following the foreclosure sale, making judicial foreclosure extremely undesirable and rarely used in California.

Non-real property collateral may also be available to lenders for certain defaults, including, for example, cash deposits, letters of credit, tangible personal property and intangible personal property. Lenders ordinarily take a security interest in existing third-party contracts as well, through direct or collateral assignments (which, although sometimes described as absolute assignments, are, in reality, only collateral assignments that spring into effectiveness upon an event of default). With some contracts, however, e.g., construction contracts, the challenge often involves keeping the contractors on the job following foreclosure and assignment of the construction contract.

Lenders sometimes take security interests in the ownership interests of their borrowers in their parent entities, typically in the case of mezzanine loans or other secondary financing. When taking a security interest in the ownership interest of a parent entity, a common fallacy among lenders is that the secured lender "steps into the shoes" of the partner or member of the parent entity upon foreclosure of the ownership-interest collateral. But absent an agreement by all of the remaining partners or members of the parent entity, statutory law provides that a lender assuming an ownership interest by foreclosure of collateral actually takes only the right to partnership/membership distributions and other economic interests. The lender does not assume voting rights or other rights of ownership beyond economic rights. Distributions are unlikely, however, when the parent entity is in default, yet such foreclosing lender may assume certain liabilities incident its economic ownership interest. Thus, under most circumstances involving borrower default where a lender's security is its borrower's ownership interest in a parent entity, literally stepping into the shoes of a partner or member may be undesirable.

Lenders can take additional security through the use of personal guaranties from borrower-principals, which, where enforceable in antideficiency states like California, provide direct access to money remedies, regardless of lenders' efforts (or lack thereof) to obtain recovery against the collateral, i.e. though foreclosure, in the case of loan defaults. Lender clients should be cautioned, however, concerning the true nature of certain guaranties, e.g., completion guaranties, under which lenders do not actually receive a guaranty that the guarantor will complete lien free construction, as courts will not order specific performance, but receive instead, a guaranty for the damages incurred by lenders upon non-completion of construction, i.e., the difference in value in the incomplete construction project versus the completed construction project contemplated in the loan documents. Lenders must be careful to take guaranties only from third parties or principals of the borrower, but not from the borrower itself, or anyone directly liable for the borrower's debts, e.g., a general partner. Under *Union Bank v. Dorn* (1967) 254 Cal. App. 2d 157, guaranties by borrowers and

general partners are subject to antideficiency defenses. Although consideration is also required to support a valid and enforceable guaranty, California courts presume consideration where a guaranty is given at or near the time of, and in connection with, the loan closing.

Lenders face numerous impediments to the remedies noted above. For example, borrowers will sometimes seek injunctions against foreclosure, challenging the legitimacy of the debt, the legitimacy of the security interest, the legitimacy of default, or assert lender liability for tortious conduct or breach of contract (actions limited only by the creativity of borrowers' counsel). Borrowers often file for bankruptcy protection, which results in an automatic stay under Section 362 of the bankruptcy code and the invocation of a host of bankruptcy court-supervised remedies and priority issues for secured and unsecured creditors. Moreover, real estate owned by lenders following foreclosure (commonly referred to as REO) presents its own problems, such as regulatory constraints on the holding of real estate that require hurried liquidation, lack of personnel or an inclination to develop and manage real estate, a host of owner-liability issues incident direct ownership, and troubled properties that usually accompany defaulted loans.

Remedies for non-monetary defaults vary according to the nature of the default, but are often difficult to enforce. Moreover, most trustees will resist, or flatly deny, proceeding with a foreclosure action to enforce remedies for non-monetary defaults.

IV. Lender Strategies to Protect Yield and Loan Performance.

Not surprisingly, commercial real estate lenders have created numerous loan structures and provisions to protect themselves against perceived risks to which they are exposed as a result of the governing laws and practical realities of financing commercial real estate, as briefly highlighted in this article. The following are a few common loan provisions and lender strategies practitioners will come across when advising real estate clients:

A. Loan Sizing and Pricing.

First and foremost, Lenders focus significant underwriting attention on properly sizing loans in relation to the income and value of the asset to protect against extending loans in larger amounts than are realistically supportable, with adequate cushion for less than perfect performance, (i) by net operating income (revenues minus assumed or actual vacancies, operating expenses, maintenance, insurance and taxes –lenders may also deduct deposits to reserves from gross income to determine NOI) generated by the asset, and (ii) by the market value of the asset-collateral. Proper loan sizing, which is a somewhat subjective viewpoint held by particular lenders with particular investment return and yield objectives and expectations, is accomplished through proper underwriting of asset operations and appropriate appraisal techniques. Lenders most commonly desire to size loans, in view of underwritten net operating income and project debt service (taking into account current interest rates and amortization schedules), so as to support a minimum debt service coverage ratio of 1.15:1 (or less) to 1:35:1 (or more). The Debt Service Coverage Ratio (DSCR) is calculated by dividing the underwritten annual net operating income by the annual debt service (or an assumed annual debt service based upon a fictitious interest rate or loan constant) on the loan. Establishing an appropriate loan-to-value ratio (LTV, or the ratio of the loan amount to the market value of the asset collateral) is also highly subject to lenders' risk/reward objectives and business models. For first mortgage loans, however (not accounting for second mortgages or mezzanine debt), the LTV is typically targeted at no more than 75% or 80% (and often less), leaving a cushion of a least 20% for market fluctuations, and loss of value, costs and expenses incurred in connection with a foreclosure and resale of the asset from the lender's or holder's real estate owned (REO) portfolio.

B. Variable vs. Fixed Rate Debt.

Lenders desire to secure certainty in yields, in light of the fact that lenders' only real upside to their loans (or portfolio of loans) is the spread they earn over their respective cost of funds (whether on a particular loan or on a weighted average basis for a portfolio of loans). Yield certainty is often accomplished through variable rate debt priced as a fixed spread over a particular index (or fixed interest rate reference) that varies with the general movement of interest rates in the bond markets, both domestically and foreign. The London Inter-Bank Offered Rate, or LIBOR, for example, is a common variable rate index. Another is fixed term US treasury notes, such as the 5 or 10-year treasury notes.

Alternatively, lenders sometimes attempt to "match funds," wherein fixed rate loans are made for loan terms roughly coterminous with targeted sources of funds, such that a lender essentially locks in a certain yield over a certain term. Fixed rate loans, however, are often subject to borrowers' desire to prepay, i.e., pay off the principal prior to the end of the agreed term, particularly when interest rates drop or property values increase, creating the desire to sell or refinance to raise capital. Fixed rate lenders, therefore, attempt to create disincentives to loan prepayment.

C. Prepayment Premiums (Penalties).

Borrowers who prepay fixed rate loans destroy lenders' planned yield and possibly leave lenders or holders of the prepaid loans holding high rate sources of funds with a lower rate potential for reinvestment. Thus, to disincentivize borrowers who might otherwise be inclined to prepay fixed rate loans, lenders, among other possible strategies, structure prepayment premiums into fixed rate loan terms (more commonly referred to by borrowers as prepayment penalties—though lenders avoid referring to prepayment premiums as penalties). Prepayment premiums come in a variety of formulas, from a flat one percent prepayment premium to the now commonplace yield maintenance formula.

Under a yield maintenance formula, a borrower functionally agrees to pay a premium over the amount required to prepay the outstanding principal balance of a loan, such premium being equal to the amount required to provide the holder of the prepaid loan a lump sum that can be reinvested at the current treasury yields with a term equal to the remaining term of the prepaid loan and providing a yield to the holder of the prepaid loan equal to what it would have earned on the loan for its remaining term, had the loan not been prepaid. Stated alternatively, a yield maintenance formula essentially calculates the discounted present value of the stream of cash flow, i.e., the yield, lost by the lender/holder of the prepaid loan as measured by the difference between the interest rate on the loan and the then-current yield on a U.S. treasury security with a remaining term equal to the then-remaining term of the prepaid loan.

D. Loan Origination, Underwriting and Servicing Fees.

A somewhat obvious but significant source of revenue and yield enhancement for lenders comes from loan origination fees, underwriting fees and other fees and charges imposed upon borrowers for the privilege of obtaining a loan from a particular lender. Moreover, lenders always pass on to borrowers virtually all costs associated or incurred with underwriting, processing,

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and conducting due diligence on real estate, borrowers, businesses, financials, etc. A significant additional revenue source comes from so-called servicing fees, which are generally added to the interest rate or spread over treasuries, LIBOR, prime, or other interest rate index for purposes of calculating the total gross, or so-called "all-in" rate on a loan. Loan servicing is the business of collecting monthly loan payments, sending statements, conducting annual property inspections, monitoring loan document compliance, including maintenance and repairs, capital replacements and the like and managing reserve accounts. Loan Servicing is priced as a certain number of basis points annually on the outstanding principal balance of a loan. Lenders often sell or assign the servicing rights of their loans, or portfolios of loans, to third party servicers or agents, who then collect the servicing fees from the loan payments, before sending the rest of the yield (or interest) to the holders of the loans (or holders of the pieces of the portfolio, as the case may be). Lenders who sell or assign servicing to third parties are paid a purchase price for such servicing equal to the present value of the servicing fees, discounted to reflect perceived risks of default, prepayment, etc., which has the effect of securing a particular yield in connection with the loan (or portfolio) and passing on the risk of default or prepayment to a third party.

E. Loan Proceeds Disbursement.

In order to avoid disbursing loan funds in excess of the existing market value of collateral, lenders control the disbursement of loan proceeds based on various earn-out provisions, such as when an asset is undergoing renovations and repositioning. The most common staging of loan disbursements occurs in connection with construction lending, where lenders seek to limit the extension of funds to amounts equal to or less than the value of improvement work completed at the project. For constructions loans, payment and performance bonds can further protect lenders, as noted above; and borrowers making change orders in construction projects that secure construction loans will generally need to obtain lender approval for such change orders. In addition to typical lender's title insurance policies, lenders will also require endorsements that bring the policy current and applicable to each succeeding disbursement.

F. Loan Participations and Syndications.

For larger loans, Lenders may spread their risk and protect their capital through (1) participations (where a lead lender invites additional lenders to fund portions of the loan, although the lead lender remains the "lender" from the borrower's perspective), (2) syndications (whereby a lead lender spreads the direct ownership of and funding responsibility for a large loan, which serves to move the syndicated loan off the balance sheet of the original or lead lender), (3) loan sales and assignments (whereby the original lender assigns the loan, typically post-closing, to a different lender or holder with no continuing role for the original lender—e.g., a multifamily lender who funds a loan and immediately sells and assigns the loan to Fannie Mae or Freddie Mac), and (4) conduits (whereby a lender funds a loan and then either sells and assigns it immediately into a pre-arranged growing pool, or pools a small or large portfolio of loans and sells and assigns them as a portfolio into a pre-arranged larger pool for securitization).

All of these risk-spreading or risk-reduction strategies impact the lender-borrower relationship. Often, borrowers will have to deal with multiple (seen or unseen) lenders or holders of the original note, or a single different lender and servicer, than they originally contemplated. Nonetheless, lenders routinely engage in these and other risk adjusting loan strategies for the purpose of securing a more reliable yield on invested or loaned funds.

V. Conclusion.

Commercial real estate lenders make their money by earning a yield on principal amounts loaned to borrowers. In the simplest analysis, lenders borrow funds from various sources, at individual cost of funds, or at a weighted average cost of funds over a portfolio of borrowings. The interest rate spread (including, or not, as the case may be, a servicing fee or spread) over the cost of funds for its principal amounts loaned, when added to origination fees, underwriting fees, etc., constitute a lender's gross profits, and hence, its upside. Numerous risks of loss to lenders' scheduled yields, including for example, risks of default, prepayment, etc., pose the continuing threat of reducing or destroying lenders' profits. The downside risks can also increase lenders' required loan loss reserves, which reduce the ability to earn yields on funds for which lenders' still incur cost, i.e. costs of funds – burdensome propositions, time-consuming and expensive. Thus, lenders have devised numerous risk reducing strategies and loan provisions to create greater certainty of yields and returns on their loan investments.

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REAL PROPERTY SECTION
Upcoming Events for 2005

SEPTEMBER 27, 2005

Smoking Guns and How to Use Them

CLE: 1 CLE hr. CODE #: 009083

For complete program information or to register,
click here: **Smoking Guns**.

Actual link: (<http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=987)

SEPTEMBER 29, 2005

Lease: Expansion Rights: Build to Suit Leases and Office Leases

CLE: 1 CLE hr. CODE #: 009084

For complete program information or to register,
click here: **Leases & Office Leases**.

Actual link: (<http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=988)

OCTOBER 12, 2005

Eminent Domain as a Redevelopment Tool in California after Kelo v. City of New London

CLE: 1 CLE hr. CODE #: 009085

For complete program information or to register,
click here: **Eminent Domain**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=989)

OCTOBER 19, 2005

Financing Tenancies-In Common – Part II

CLE: 1 CLE hr. CODE #: 009086

For complete program information or to register,
click here: **Tenancies-In Common**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=990)

OCTOBER 25, 2005

Construction Indemnity Clauses: Who Bears the Burden of a Mistake

CLE: 1 CLE hr. CODE #: 009088

For complete program information or to register,
click here: **Indemnity Clauses**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=992)

OCTOBER 27, 2005

A Review of Recent Supreme Court Cases that Concern Real Estate Law

CLE: 1 CLE hr. CODE #: 009087

For complete program information or to register,
click here: **Supreme Court Cases**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=991)

NOVEMBER 2, 2005

Working with Environmental Regulators

CLE: 1 CLE hr. CODE #: 009093

For complete program information or to register,
click here: **Environmental Regulators**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=997)

NOVEMBER 15, 2005

Bankruptcy Update – The Impact of the New Bankruptcy Law on Title Insurance

CLE: 1 CLE hr. CODE #: 009094

For complete program information or to register,
click here: **Bankruptcy Update**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=998)

Place: The Olympic Collection, 11301 Olympic Blvd., Suite 204, Los Angeles, 310-575-4580

Time: Registration: 11:45 a.m.–12:30 p.m.; Lunch: 12:00 p.m.; Program: 12:30–1:30 p.m.

Prices: Free CLE+*PLUS* members (meal not included); $35 law students (meal included); $65 real property section members; $75 other LACBA members; $85 all others ($85 all at the door payments)

NOVEMBER 16, 2005

What Happens If I Don't Get This SNDA?

CLE: 1 CLE hr. CODE #: 009095

For complete program information or to register,
click here: **SNDA**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=999)

NOVEMBER 29, 2005

Fundamentals of Insurance for Construction

CLE: 1 CLE hr. CODE #: 009096

For complete program information or to register,
click here: **Insurance for Construction**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=1000)

DECEMBER 7, 2005

Ethics and Environmental Law: Handling Self-Reporting of Legal Violations, and More

CLE: 1 CLE hr. CODE #: 009097

For complete program information or to register,
click here: **Ethics & Environmental Law**.

Actual link: (http://calendar.lacba.org/calendar/index.cfm?fuseaction=ViewCalendarEvent&CalendarEventID=1001)

To view all programs for 2005, please download a copy of the Section calendar *(adobe pdf)*, click here: **Section Calendar**.
Actual Link: (http://www.lacba.org/Files/Main%20Folder/Sections/Real%20Property/Files/2004-05%20Real%20Property%20Calendar%20(final).pdf?CFID=8131&CFTOKEN=69949664).

MCLE Program: All About MERS

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By: Tim Farahnik, DLA Piper Rudnick Gray Cary US LLP

What is MERS?

MERS stands for Mortgage Electronic Registration System, and it is an all-electronic registry for tracking servicing rights and beneficial ownership interests in mortgage loans. MERS is *not* a system of recording; rather, it is a system of tracking mortgages that allows a person to determine where mortgages are recorded, who the servicer is, and the original amount of the note secured by the mortgage or deed of trust.

How Does MERS Work?

MERS serves as the mortgagee or beneficiary of record on mortgages or deeds of trust recorded in the county land records. The borrower conveys the property to MERS under the mortgage or deed of trust, agreeing that MERS holds legal title to the property and that MERS has all rights of a mortgagee, including foreclosure (although such a foreclosure will be pursued by the actual lender, through MERS). If MERS is not the original mortgagee, the mortgage may be assigned to MERS. Each loan is assigned a unique Mortgage Identification Number, which appears on the mortgage or deed of trust and follows the loan from registration to payoff. Once MERS is designated as the mortgagee of record, there is no need to prepare and record documents reflecting assignment when loans are transferred between MERS members, as MERS remains the mortgagee in the land records. This reduces paperwork, eliminates recording fees, decreases chain of title issues and eases delivery of mortgages into the secondary financing market. When the servicer receives a final loan payoff, an officer of MERS executes the lien release.

How is MERS Structured?

MERSCORP, Inc. is the operating company that owns the MERS system. Mortgage Electronic Registration Systems, Inc. is the bankruptcy-remote, wholly-owned subsidiary of MERSCORP, Inc. whose sole purpose is to serve as the mortgagee in the land records for loans registered on the MERS system.

Who Makes Up MERS?

MERSCORP, Inc. is comprised of 28 shareholders divided into three classes. Class A members are Fannie Mae, Freddie Mac and the Mortgage Bankers Association, who hold veto power over the affairs of the company. Class B members include Charter One, Chase Manhattan, Merrill Lynch, Washington Mutual and Wells Fargo, and hold 10 of the 15 board positions in the company. Class C members include the ALTA, First American Title and Stewart Title, and own about 10% of the stock of the company.

How Does One Become a Member of MERS?

All members must enter into a Membership Agreement with MERSCORP, Inc., which can be downloaded from the MERS website, *www.mersinc.org*. The Membership Agreement states that MERS shall serve as their nominee as mortgagee in the county land records in exchange for the member registering the mortgage on the MERS system. MERS performs due diligence on all potential members so as to reduce the chance of fraud using the MERS system.

Where Can MERS Be Used?

The conveyance language used to designate MERS as the mortgagee of record is legal in all 50 states and in every county in the U.S. MERS uses attorneys in every state in order to ensure continuing compliance.

Who is Using MERS?

Over 29 million loans are currently registered on the MERS system, comprising over 25% of outstanding debt in the U.S. An average of 26,000 new loans are registered on MERS daily, which constitutes over 50% of newly originated loans. About 2,000 companies are actively using MERS, including 29 of the top 30 lenders in the U.S. who use MERS in at least one division.

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Top 10 Lease Issues

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By Robin Ratner

Before entering into a commercial lease, a Letter of Intent requesting a proposal of terms for leasing space is the first contact the tenant will have with the building owner.

The Letter of Intent should include basic primary concerns: lease terms; rental area base annual rental rate; cancellation provisions; right to sublease or assign; options to expand, options to renew lease terms; proposed use; operating expenses; and moving allowances.

The advantage of sending out several proposals prior to the time required to move, will provide the tenant an opportunity to investigate several sites, commercial rates and degree of flexibility. The Letter of Intent is the process of preliminary negotiations.

Herein below are ten issues of import to every commercial lease intended to protect both tenant and landlord interests.

1. Subleasing

A. The Right

The right to sublease and/or assign is of paramount concern to most commercial tenants. The tenant will want the right to sublease, assign or otherwise occupy any portion of its leased space. The tenant's provision should include the ability to sublease or assign not only by the tenant but the tenant's affiliate companies or subsidiaries and any entity that subsequently acquires the tenant's company in order to avoid the disruption of business and to avoid possible deterrence of the buyout.

B. The Revenues

The lease terms should provide a provision that the tenant will keep all revenues derived from subletting or assignment. This will insure the tenant will be responsible for the subtenant as opposed to the landlord having to work with multiple parties on a single lease.

C. Consent

The lease terms should include that the Landlord will not unreasonably withhold consent to sublet or assign. The landlord should provide the request to lease and the consent thereon, in writing to avoid future misunderstandings leading to litigation for breach of lease terms, particularly as to the issue of usage.

D. Options

The right to sublease or assign should also include options that are exercised to extend the term of the lease of the tenant's lease to avoid disruption of the tenant's interest. It is not uncommon for a tenant to exercise a five year term with a five year option. The subleases should be afforded the same option in order for the tenant to calculate rental costs for the leased squared footage in determining whether it is possible to exercise the option.

E. Default

In the event of tenant default, the landlord should recognize the sublease as a direct lease between landlord and sub tenant. The landlord should include a provision that the rent will be increased by the increase of square footage, the subtenant has now assumed in the event of tenant default. The provision will ensure that the subtenant can continue its interests uninterrupted and the landlord will continue to receive the same rent as if the default had not occurred.

2. Operating Expenses

Typical operating expense to the tenant should exclude:

a. ground lease rental

b. capital repairs, replacements, improvements and equipment (Capital Items)[1]

c. rental of capital items

d. costs incurred by landlord for repairs to the building to the extent the landlord is reimbursed by insurance proceeds and costs of all capital replacements (whether covered by insurance proceeds)

e. cost of earthquake repairs

f. permits, license, and inspections costs incurred with respect to installation of tenant improvements

g. depreciation, amortization and interest payments for contracts entered into with landlord and third parties for the benefit of landlord

h. marketing costs, leasing commissions, attorneys' fees in connection with the negotiation and preparation of letter of intent with prospective or present tenants.

i. expenses incurred for benefits not offered to tenants.

j. interest, principal, points, fees on debts or amortization on mortgages encumbering the building or the land.

k. landlords general corporate overhead including general and administrative expenses.

l. expenses incurred by landlord for concessions such as parking.

m. advertising and promotional expenditures for the building and signage for landlord.

n. electric power used by the tenant in the building.

o. costs incurred in connection with upgrading the building to comply with ADA and other current laws.

p. costs for which landlord is compensated by a management fee.

q. costs during the contractual warranty period from construction defects in the base, shell or core of the building or improvements installed by landlord.[2]

3. Square Footage

The square footage is measured by the BOMA (Building Owners and Managers Association) Method of Measurement set forth in ANSI Z.1-1996. The tenant should have a reasonable period of time (90 days) to determine if it agrees with the landlord measurement of square footage for the lease term. If a dispute arises there should be a provision where the dispute should be resolved by arbitration with the prevailing party to receive either the additional rent, in the case of the landlord or a rebate of overpayment to the tenant.

4. Tenant Improvement Construction

Normally the tenant hires the designer to design the tenant improvements. A provision for improvement should be well constructed to avoid any dispute after costly improvements were made.

1 Exceptions could include amortization of the useful life of costs, including financing costs incurred by the landlord and required by changes in law for capital improvements purchased or incurred as a labor saving measure or to affect other economics in the operation or maintenance of the building.

2 The exclusion list is a sample of possible items and not intended to represent all exclusions allowable.

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5. Commencement Date and Construction

The Commencement Date (first date of rental period) will normally be a time period negotiated by the landlord and tenant allowing sufficient time to complete tenant improvements. There should also be a provision for delays caused by either the landlord or Force Majeure to avoid delay penalties.

Tenants should also negotiate a time period to move in over a weekend prior to the Commencement Date to further avoid additional loss of business time during which rent accrues.

6. Tenant Improvement Allowance

The amount is usually agreed upon by the landlord and tenant in connection with the establishment of the rental rate. A well known corporation may be able to negotiate a very low rental rate because of its credit rating. The tenant should ensure the tenant improvements can be used for design costs, project manages, consultants, furniture, etc in addition to the actual cost of construction.

7. Disbursement of Tenant Improvement Allowance

A Non-Disturbance Agreement is an important provision when drafting the lease in the event of landlord default. If the landlord defaults on the loan to the lender, typically, the lender will foreclose and the landlord will have no equity interest in the building and therefore no money to disburse to the tenant for tenant improvements. The tenant should insist upon receiving a Non-Disturbance Agreement from the lender whereby the lender will agree that in the event it forcloses upon the lease, the lender will recognize the lease between landlord and tenant as between tenant and lender.

The Non-Disturbance Agreement should also include event of prior default, that is if the landlord defaulted on the tenant improvements prior to defaulting on the loan to the lender. It is a common scenario wherein tenants find they are not covered in the midst of construction if the Non-Disturbance Agreement does not address prior default to lender's loan.

8. Subordination, Non-Disturbance and Attornment Agreement

The provision should provide that the landlord agrees that prior to the Commencement Date, exhaustion of Tenant Improvements or twenty days after the date of full execution of the Lease, it will provide without cost, a non-disturbance, subordination and attornment agreements in favor of the tenant from any ground lessors, mortgage holder or lien holders ("Superior Mortgagee") then in existence. It should be recorded, usually a cost incurred by tenant. Landlord's failure to provide the non-disturbance agreement gives rise to the tenants termination of the lease. The non-disturbance agreement should provide for the Tenant Improvements required to be completed, to be an expense of the landlord, as well as tenant's broker commissions.

The purpose of the non-disturbance agreement is that in the event a Superior Mortgagee becomes the beneficiary of the deed of trust, the tenant will continue its lease under the same terms and provisions as if the landlord had not either defaulted, or sold the building. The agreement is reciprocal in that if the tenant default after the Superior Mortgagee has assumed the deed of trust, the tenant is responsible for the terms of its lease, as the Superior Mortgagee steps into the shoes of the landlord.

The provision is key to the tenant's assured continuation of its business operations in the event the building is bought or under new ownership due to default. Failure to provide for a non-disturbance agreement could give rise to situations wherein in the midst of Tenant Improvements or somewhere in the second of a ten year lease, the tenant finds himself being notified of the termination of the lease, as the new owner is not bound by previous agreements, unless the non-disturbance agreement is executed by the landlord and third party.

9. Condition of "As Is"

The base building description is importance to both the landlord and tenant. A comprehensive description should be included so the tenant can accurately assess how to be use Tenant Improvements. In many instances the landlord will prefer to have the tenant accept the building in its "as is" condition. Protections for the tenant should include the building systems and structures will be delivered in good condition and working order. If the building is an older structure it will be important that the provision include the building systems and structure be in compliance with current codes and applicable laws or set forth variances grandfathered to the landlord.

The result of failure to obtain the actual condition, is the tenant could find the systems inadequate or not in code compliance and the tenant is forced to incur the expense of the necessary upgrade, thus, depleting its Tenant Improvements.

10. The Right To Audit

Where there are disputes over additional rent, the tenant should have the right to proved notice to the landlord, the tenant intends to inspect the books and records with a third party auditor. The agreement to audit should include a provision that the landlord is required to support all documentation concerning the accounting of the additional rent as set forth in the supplemental rent statement provided to the tenant. The arbitration shall be binding upon the parties and which party bears particular costs of the audit and arbitration.

The above is a list is an over view of just 10 issues; however, the issues are germane to all commercial leases and lease issues that must be resolved prior to the executing of a commercial lease.

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A Mechanic's Lien Primer

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By Thomas F. Quilling, Holland & Knight LLP

Overview

The basic purpose of the California mechanic's lien law is to afford security for those who enhance the property of others. The mechanic's lien law is a remedial statute that is liberally construed in favor of the claimant. It is based on express provisions of the original California Constitution (1879). Article 14, § 3 of the California Constitution now provides: "Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and material furnished; and the Legislature shall provide, by law, for the speedy and efficient enforcement of such liens." Even if the owner pays the general contractor, but the money does not get to other parties who worked on the project, the owner is still responsible even though they already paid for the work. This means that an owner might pay twice for the same work. This is a unique aspect of the law which applies only to mechanics' lien laws.

Surprisingly, "the mechanics' lien is the only creditor's remedy stemming from the constitutional command and our courts 'have uniformly classified the mechanics' lien laws as remedial legislation, to be liberally construed for the protection of laborers and materialmen.'…'[s]tate policy strongly supports the preservation of laws which give the laborer and materialman security for their claims.'" *Coast Central Credit Union v. Superior Court* (1989) 209 Cal.App.3d 703, 708. "No other 'creditor remedy' in this state enjoys such a constitutionally enshrined status." *Connolly Development, Inc. v. Superior Court* (1976) 17 Cal.3d 803, 808.

Liens attach directly to a piece of property ("Work of Improvement", California Civil Code Section 3106), not to a person, and unlike any other lien process there is no requirement in California for the contractors to go to court prior to filing a mechanics' lien. However, there are several steps that are required to maintain the lien rights. The basic requirements are that the owner is provided notice of work being performed, and the mechanic's lien statutory timelines are met. If a contractor fails to give notice and/or lets deadlines expire they lose their right to place or pursue a mechanics' lien. Once a mechanics' lien is placed on a piece of property the contractor must start a Lien Foreclosure Action within 90 days.

Recently, Timothy M. Truax of Cox, Castle and Nicholson LLP and Helen J. Lauderdale of Sheppard Mullin, Richter & Hampton LLP presented a comprehensive lunch program wherein they discussed basic California mechanics' lien law, stop notice claims on private and public works, payment bonds on private and public works, and owner security for payment to contractor.

I. The Steps to Protecting and Enforcing Mechanics' Lien Rights

There are three basic steps required before a contractor can recover money through a mechanics' lien:

1. Notice to the owner
2. Recording the lien
3. Lien Foreclosure Action

Issues to Remember

1. Mechanics' liens are a claim against the Work of Improvement not people
2. Notice to the property owner must be given
3. Statutory timelines and deadlines must be met to maintain lien rights
4. The lien must be foreclosed through a lawsuit

II. Preliminary 20-Day Notice to the Owner

California requires that the property owner must know about the specific work being done before the property owner can be held responsible. The theory is, if the property owner knows who is working on their project they can make effort to see that they are paid. California Civil Code §§ 3097 and 3114 requires that all claimants, except the original contractor (direct contractual relationship with owner), individual laborers, and union trust funds, must give preliminary lien notice no later than 20 days after they first furnished labor, services, equipment or materials to the project. A claimant can give notice late, but lien rights extend "back" only 20 days.

California mandates the use of a special 20-Day Preliminary Notice form the contents of which are set forth in Civil Code § 3097. The form must be filled out and copies sent by certified, return receipt mail to the property owner, lender and prime (general) contractor within 20 days of starting work on the project.

Issues to Remember

1. A claimant must send a 20-Day Preliminary Notice if they are not the original contractor, individual laborer, or union trust fund.
2. The Notice must be sent to the Owner, General Contractor, and Lender if any.
3. The preliminary notice must be sent by certified or registered mail with return receipt.
4. Labor (individual workers) has lien rights without giving notice.

III. Recording the Lien

The claimant must timely record mechanics' lien (California Civil Code §§ 3115-3117). The lien must be recorded in the county where the work of improvement is located. The timing to record the lien is dependent on three factors:

1. If a Notice of Completion is recorded the original contractor has 60 days to record its lien and all others have 30 days, ***but,*** the Owner must now give notice that a Notice of Completion has been recorded in order for shortened period to apply.
2. If a Notice of Cessation (cessation of work on the work of improvement for 30 days or more) is recorded the original contractor has 60 days to record its lien and all others have 30 days.
3. If neither Notice is recorded (or the notice of recording is not given by Owner) all claimants have 90 days after "completion" to record their liens. "Completion" is defined in California Civil Code § 3086 as follows:
   a. Occupation or use of work of improvement by owner accompanied by cessation of labor.
   b. Acceptance of work by owner.
   c. Cessation of labor for a continuous period of 60 days.
   d. Acceptance by public agency.

Issues to Remember

1. Record in the county in which the project is located.
2. Must record lien within 90 calendar days of the completion,
3. Must record lien within 60 calendar days for original contractor and 30 calendar days for others should a Notice of Completion or Notice of Cessation be recorded (unless the owner fails to give notice that the Notice of Completion has been recorded).

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REAL PROPERTY SECTION

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Community Outreach Program

ABA/LACBA REAL PROPERTY SECTION
COMMUNITY OUTREACH PROGRAM & SCHEDULE
LACBA/LexisNexis Conference Center, 281 S. Figueroa St., Time: 6:30 – 8:00 p.m.
Complimentary Program, courtesy of the Real Property, Probate and Trust Section of the American Bar Association and the Real Property Section of the Los Angeles County Bar Association

The Real Property Section of the Los Angeles County Bar Association and the Real Property, Probate & Trust Section of the American Bar Association are jointly sponsoring a real estate law program that will consist of eleven complimentary seminars on real estate law practice. This series of programs is similar to those put on by the ABA in conjunction with local bar Associations in New York, Chicago and Washington, D.C. The seminars will be held on consecutive Wednesdays from 6:30 to 8:00 pm from September 14th to December 7, 2005 at the LACBA offices at 281 South Figueroa Street. They are particularly designed to enhance diversity among real property practitioners and to facilitate the entry of new attorneys into the real property practice. The ABA will provide MCLE credits, free of charge, to all attendees. Light refreshments will be served.

9/14/05 - Basic Introduction - Role of Counsel
Buy and Sell - Residential Real Estate; CAR Form; Seller disclosure and other statutory obligations of brokers and escrow agents; Predatory lending

9/28/05 - Title and Survey
Title commitments; Reviewing title documents; Reading surveys; Title insurance

10/5/05 - Buy and Sell - Commercial Real Estate
The agreement; Due diligence; Estoppel certificates; Disclosure requirements; Closing mechanics

10/11/05 - Residential Disputes
Landlord/Tenant; Easements; Boundary disputes; Light and air (and views); Drainage

10/19/05 - Commercial Real Estate Financing
Basic documents; "One Form of Action"; Anti-deficiency laws; "Conventional" vs. securitized loans

10/26/05 - Commercial Real Estate Leasing
Form of lease; Rent escalation clauses; Assignment provisions; Responsibility for maintenance and code compliance; Remedies

11/2/05 - Some Taxing Questions
Proposition 13 and its progeny; Real estate transfer taxes; 1031Tax-deferred exchanges

11/9/05 - Land Use and Environmental Laws: Zoning & CEQA; CERCLA and other Hazardous Materials Laws
Zoning; CEQA and other environmental laws

11/16/05 - Construction Agreements and Disputes
Mechanic's Liens

11/30/05 - Development Subdivision Map Act
CCRs; Condominium development and conversion; California Department of Real Estate (DRE)

12/7/05 - Ethics/Opinion Letters
Final Wrap-Up

For information or to register, e-mail or fax Trudi Lesser or Tom Quilling at:
Trudi Lesser: tlesser@sswesq.com; fax: 213-229-2870; or
Tom Quilling: thomas.quilling@hklaw.com; fax: 213-896-2450.

Registrations for these events are being handled by Trudi Lesser and Thomas Quilling. Please do not send any registrations for the above ABA events to the LACBA.

ARTICLES FROM THE

2005 Benjamin S. Crocker Symposium

Note from the Editor

The Crocker Symposium was quite a success this year. In order to take advantage of the great programs and to make sure those who were unable to attend obtain the information that was presented at the event, the following are articles which summarize the seminars. I hope you enjoy them.

Daniel Goodkin
Real Property Review Editor Editor

Regulating and Subsidizing Superstores: The Big-Box Paradox

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by: Lawrence G. Permaul
Nossaman Guthner Knox & Elliott

On April 21, 2005 the University of Southern California and the Los Angeles County Bar Association held its annual Benjamin S. Crocker Symposium on Real Estate Law and Business 2005. As part of the program, George Lefcoe of the USC Gould School of Law moderated a discussion about regulating and subsidizing superstores such as Wal-Mart and Costco. The discussion panel included Mark R. Wolfe of M.R. Wolfe & Associates, Philip R. Recht of Mayer Brown Rowe & Maw LLP and Joel Benoliel from Costco Wholesale Corporation. The following article addresses issues presented by the discussion.

Big box developments and large retail stores offer communities the prospect of consumer savings, time convenience and increased tax revenue. However, these benefits may be offset by lower wages, increased traffic and other negative impacts on the environment. The debate over these benefits and disadvantages has been highly contentious. While some communities have welcomed the "superstores," several local city and county governments across the state of California have passed, or are considering, ordinances that seek to restrict or ban big box developments. The ensuing battle over big box development raises the question of whether use of zoning ordinances can be properly used to ban or obstruct legitimate business activity.

Definition of Big Box

There is no single definition of a superstore or big box development. Most definitions tend to focus on the square footage of the stores instead of the products sold. On average, big box developments are 100,000 square feet or more with "super centers" reaching 250,000 square feet. Still, the amount of square footage required to qualify as a big box development may depend on the goods sold inside. The classic example and currently the most contentious prototype big box development is Wal-Mart. Without doubt, Wal-Mart is a target because of its shear size and the leverage it commands. The gross domestic product of Wal-Mart rivals the GDP of Canada. Similarly, Wal-Mart is the number one national retailer in grocery sales. In addition to their size, Wal-Mart is often recognized for its efficiency and ability to control costs. As part of their impressive business plan, Wal-Mart opposes efforts to unionize its employees. In reaction, employee advocates have responded by joining with grocery stores, residents, local officials, and environmental groups to pass ordinances and zoning restrictions that limit the development of Wal-Mart stores.

Effects on Local Communities

There is little argument that the introduction of big box retail that includes grocery products will significantly reduce the price of groceries for consumers. Advocates of big box development argue that these savings will raise net incomes and may create additional employment if the excess money is spent on regional goods and services. Meanwhile, critics suggest that introduction of big box retail that includes grocery products will produce wage declines and job loss in the grocery sector. Studies differ in their analysis of whether consumer savings will offset grocery job losses and produce either a net positive or negative effect on local economics. There is a possibility that although the super centers will pay lower wages to employees, the introduction of those super centers might lead to the employment of more people. On the other hand, despite an overall increase in employment, the value of those individual jobs and their benefits may produce less employee income and community benefits prior to the introduction of the superstores. Further, the lower prices may also lead to downward pressure on wages in general, not only lowering living standards for grocery employees, but also causing a negative "ripple effect" on the regional economy.

Whether big box developments will yield a net increase in city and county tax revenue is also debatable. Super centers that also offer grocery sales, which are generally exempt from state sales tax, will often increase physical size at a less than proportional increase in tax revenue. In addition net sales tax revenues may be reduced if the low cost super centers displace existing sales at competing grocery stores. Negative federal tax implications may result from lower taxable wages and the increased cost of various health and social benefits no longer offered by the employer and passed along to the government. Yet other urban planners contend that big box development can be the harbinger necessary for smaller, community-oriented redevelopment projects, because it generates the money needed to finance other development. Advocates suggest that the big box development will act as an anchor tenant and create a synergy that will attract consumers and facilitate growth.

Beyond the economic considerations, environmental concerns can play a substantial role in determining whether a super center will be developed. Under California environmental statutes, environmental impacts such as land use; air quality, noise and traffic must be adequately addressed prior to the approval by a public agency. The environmental review requirement has been successfully used to stop Wal-Mart developments in several communities based on the conclusion that the resulting environmental damage outweighed any potential benefit. In response, Wal-Mart has filed several lawsuits challenging the use of zoning ordinances to restrict or ban its proposed developments.

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Benjamin S. Crocker Symposium on Real Estate Law and Business

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April 2005

Report on Breakout Session 2-A

BY: Lydia Lee, Esq.

Current Issues in Condominium Conversion Projects

Most developers, contractors and investors in the real estate industry have been reluctant to tap into the for-sale condominium market for several decades. Potential construction defect litigation that can arise years after construction completion and the difficulty of obtaining insurance coverage for such risks has made this market less attractive. However, the condominium conversion market has exploded in the past four to five years and terms such as condominium conversions, adaptive reuse, smart growth, infill and urban renaissance have become part of our daily lexicon. In Los Angeles, most condominium projects have not been ground up projects. Thanks to the Adaptive Reuse Ordinance, existing and/or vacant apartments and historical, office and industrial buildings are quickly being converted into for-sale residential condominium projects.

To discuss what fueled this condominium conversion market, its outlook and some of the current issues being tackled by the major players, Bryan C. Jackson of Allen Matkins Leck Gamble & Mallory LLP, moderated a panel of experts in the insurance, developer and contractor communities: Mark Daoussis, an insurance broker with Countrywide Insurance Services, Jeff Lee, president of The Lee Group, Inc., who has developed large adaptive reuse conversion and ground up projects in the Southland, such as the Flower Street lofts, the first for sale lofts project in downtown Los Angeles, and Joseph Martino of Howard S. Wright Construction Co., a general contractor who has also worked on the Flower Street Lofts and is currently working on the Elleven projects, the largest for-sale condominium project in downtown LA in the next 12-24 months.

Mr. Lee started developing in downtown LA in early 2001, and at that time, most projects were done as for-lease apartments with historic tax credit received from the local government. Today, he has hundreds of condominium units under construction, and as the cost of construction goes up, he predicts that more of his projects will be conversions instead of ground up. Absorption has been great as his projects are close to sold out by the time he delivers the first unit. Mr. Martino has also been fully committed to downtown LA, and foresees that his firm will continue to be heavily involved in downtown projects at least for the next five years.

However, the risk for potential construction defect litigation has not ameliorated and the introduction of SB 800 (codified as Title 7 of the Civil Code (Division 2, Part 2)) has not helped conversion projects as this law, by its terms, does not apply to condominium conversions.[1] What has changed?

I. Changes Fueling the Demand for Condo Conversions

Low interests rates, Los Angeles' Adaptive Reuse Ordinance and other incentives offered by the City seem to have opened the doors for conversion projects. Futhermore, according to Mr. Lee, as the market was coming out of the last recession in 1993-1995, the availability of affordable single family homes had dropped dramatically and many buyers did not want, did not need or could not afford a single family detached home. With the price of detached single homes escalating exponentially and the availability of land diminishing, vertical growth became inevitable and buyers who could not afford single family homes have been willing to settle for condos and those who could not afford units in ground up projects have been able to buy less expensive units in conversion projects.

A notable change in demographics (i.e., a significant number of single households and increasing number of families without children) and a fundamental change in what buyers want (urban life, easy access to cultural venues and amenities, convenience, shorter commute) have also fueled this unprecedented growth. Mr. Martino also noted that in apparent contradiction to what naysayers have been asserting for years, those who chose to live in Los Angeles have been able to attract others and are taking the lead in demonstrating the possibility of the "live-work" experience in downtown LA.

II. Allocating Risks and Creating High Quality Products

Unlike condos that are built from the ground up, developers and general contractors encounter additional hurdles in condo conversions due to problems occurring within the previous structures. The previous structures, for example, may be older buildings that do not meet today's seismic and fire safety standards.[2] Leakage and hidden decay in balconies and inadequate waterproofing in underground parking in older structures also pose a set of challenges in the conversion process.[3]

Given the inevitability of construction defect claims, the panel indicated that it has become critical for those involved in the industry to (1) offer high quality products with structural upgrades, (2) offer excellent warranty service beyond the minimum levels required by law, (e) structure deals in a manner that properly allocate risks and minimize finger-pointing, and (3) invest intellectual and financial capital in learning the ways of the insurance industry to obtain adequate coverage.

A. Converting Non-Residential Structures into Residential Structures

The complexities and risks of converting non-residential structures into residential ones present additional layers of challenges facing the conversion industry. Some, like Mr. Lee, add additional "new" units on top of the existing "old" structure, which increases the complexities and challenges involved. It is much easier to convert apartments into for-sale condos. For example, non residential structures do not have the wall assemblies that an apartment would have such as two layers of dry walls with air spaces and acoustic caulking.

To convert non residential buildings into residential projects, developers are undertaking total gutting (as opposed to mere cosmetic conversion), which means nothing is left except the four walls, some floors and parts of the roof.

1 SB 800 has become effective in January 1, 2003. One of the factors that motivated the legislature to enact SB 800 was the difficulties that residential developers were having in obtaining liability insurance due to an explosion of construction defect litigation. SB 800 is an attempt to revolutionize the resolution of residential construction defect claims. It sets statutory building standards in Civil Code §§896-897 and makes builders strictly liable for violations of such standards whether they have caused physical injury or not. Builders are given an absolute right to repair and homeowners who refuse to grant the right to repair may not file suit. See 2 Acret, Cal. Construction Contracts and Disputes (Cont. Ed. Bar 3d ed. 2004) Residential Construction Defect Litigation Under Title 7 §§ 12.1,12.4.).

2 Amanda Paxton, *Back to the City*, Real Estate Southern California, May 2005 at 50.

3 Erin Cassin, *Will Conversions Go Cold?*, Real Estate Southern California, April 2005 at 23.

There are many advantages to total gutting. First, total gutting allows builders to install structural upgrades — for example, it tends to allow for better sound abatement as new acoustic structures are put in.[4] Second, insurance companies look at condominium conversions that undergo total gutting much more favorably than those that only go through cosmetic changes ("lipstick conversions"). Mr. Daoussis noted that it is more difficult to obtain primary liability insurance and next to impossible to obtain excess liability coverage for lipstick conversion projects due to the complete uncertainty of what consists of "new work" as opposed to "old work."

B. Structural Upgrades, Homeowner Warranty Programs and Third-Party Consultants

The panel highlighted that the conversion industry is focused on building high quality products and providing adequate repair, warranty and training programs to homeowners to avoid legal action from the outset. For example, noise has been a recurring issue especially for retirees who are used to living in single homes and are sensitive to hearing flushing on the other side of the wall or people walking across marble upgrades. In response, the builder performs sound upgrades, places sound attenuation materials on the floors, and hires acoustic consultants who provide recommendations and training regarding sound isolation to mechanical, plumbing and electrical consultants before these subcontractors install their products.

Furthermore, insurance companies require that builders include third party consultants such as independent water proofing and independent roofing consultants in the construction process. Mr. Lee stated that he hires several independent consultatns and also hires a company to prepare homeowner association maintenance manuals and properly train homeowners' associations (HOAs), property managers and home owners on how to maintain their homes. Often times, the developer stays on the boards of the HOAs to monitor the needs of the homeowners. The Lee Group has a policy to "when in doubt, fix the problem" in order to keep each homeowner happy from the time the initial complaint arises. Both developer and general contractor should keep enough money in reserves to be able to service the homeowners as part of their warranty programs.

C. Quality Control

Quality control is another important way in which the industry is attempting to minimize potential claims. Insurance companies require that developers retain third party quality control consultants who regularly monitor and inspect operations in the construction site and document the progress of a project from beginning to end. Quality control providers check the progress of an operation, videotape the open items, send a punch list of open items for operations they have inspected, allow the developer to view such open items through video tapes, and after the developer is able to correct the open items and report that the items have been closed, quality control providers then return to the site to video tape and document the closed items. For their protection, these quality control firms and developers should separately keep track and document the punch list items and the resolution of each of them.

D. Design-Build

Another significant change in the industry is that developers and contractors are electing to employ the design-build structure (as opposed to the design-bid-build structure) in their attempt to minimize costs and potential liability. In the typical "design-bid-build" structure, the developer retains architects and engineers who prepare the construction documents in phases depending on the developer's needs and budget: from schematics, to design development drawings to construction drawings (which are detailed plans and specifications submitted to the contractors and subcontractors for bidding and construction). The contractors and subs, in turn, rely on the accuracy of those plans and specifications in preparing their estimates for the project for the cost of labor, equipment, and materials, plus a markup for overhead and profit. No matter how carefully the construction documents have been prepared, problems can arise during performance of the contract because of errors, omissions, ambiguities, conflicts or lack of coordination of the plans and specifications.[5]

"Design-build" is an increasingly popular structure where a single entity (the design-developer) undertakes both design and construction of the project and developers have a single-stop shopping experience. One of the advantages to a developer using the design-build structure is that the contractor is fully responsible both for the design and the construction of the project therefore eliminating the risk of claims for design errors. Thus, if delays or construction defects occur, the developer may avoid the problem of trying to discern whether the problem is the fault of the contractor, architect or engineer.[6]

Pricing structures include cost plus and lump sum structures. In the cost plus structure, the contractor is paid for all of its costs of performance (labor, material, equipment, management and other services) plus an additional percentage of overhead and profit. In the lump sum structure, the contractor agrees to perform the project for a lump sum or fixed price. These methods of pricing tend to be used on particular types of projects and are driven by factors unique to those projects.[7]

Cost plus structures are generally employed for types of projects where the contractor has no basis to make a cost estimate or would have to include a large contingency.[8] For example, the renovation of existing structures where the cost of performance may be significantly affected by conditions that cannot be known until- work begins would be more amenable to a cost plus pricing structure[9] Lump sum structures, on the other hand, are generally used for projects where pricing certainty is desired and the owner is willing to pay an additional sum representing the "price for certainty." General contractors typically have to add contingency costs to their lump sum prices, but the owner is willing to pay the extra costs. In exchange for the additional costs, contractors accept the risk of all cost overruns not caused by the developer/owner.[10]

E. Adequate Insurance Coverage

In addition to building products that are more lawsuit-proof, builders devotes a significant amount of time and resources to carefully examine and negotiate their insurance policies in order to make sure that he obtains the best coverage possible. Mr. Martino stressed the importance of working with parties with adequate insurance coverage. He walks away from a potential deal unless he can obtain satisfactory answers to the following three questions: (1) who is the developer?; (2) is condominium

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4 The panel observed that despite all the care that goes into sound abatement, it is important to have a CC&Rs stating that the building is not sound proof and train condominium unit owners to be more considerate to their neighbors than those who live in single family homes. Owners' representations and disclosures should be carefully crafted — instead of representing that the unit is sound proof, one should represent that the building has been engineered and reviewed for sound abatement.

5 1 Acret, Cal. Construction Contracts and Disputes (Cont. Ed. Bar 3d ed. 2004) Design-Build § 2A.2.

6 Id. at §2A.2, §7.4.

7 Stephen V. O'Neal & Paul W. Berning, U.S. *Construction, Architecture and Engineering Industry: An Overview for International Investors*, Feb. 2, 2004, **http://www.constructionweblinks.com/Resources/Industry_Reports__Newsletters/Feb_2_2004/us_investors.htm**.

8 Id.

9 Id.

10 Id.

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development the client's business? (the potential developer must be dedicated to building quality products and staying in the business for at least 24-36 months after completion of construction), and (3) what kind of insurance coverage is the developer obtaining? (the client's insurance policy must be a stand alone policy with adequate coverage and for the right dollar amount). It is important to confirm that separate companies building separate projects are not under one insurance policy because one policy means one set of limits. When one policy covers multiple projects and a certain project is affected by casualty, there is no certainty that other LLCs will hear of the depletion of the aggregate limits.

The insurance industry is an extremely reactive one and its products are quite volatile. Insurance companies attempt to insulate themselves from the most recent claims and price coverage for such claims as to make them unaffordable. For example, because nearly 100% of the condominium projects have had some type of potential litigious situations arise in the last 15 years, sub-contractors have not been able to obtain adequate insurance if the project includes any "residential" element. Despite the high cost of insurance, those involved in the condominium conversion market cannot afford not to purchase adequate coverage. This also means that smaller developers continue to be driven out of the market as they cannot justify the costs of insurance for smaller projects that cannot generate sufficient revenues that make such costs worthwhile.

Wrap Up Policies

Wrap up insurance policies are becoming a fixture in the construction industry under the banner of cost savings. Developers are providing Owner Control Insurance Programs (OCIPs) and general contractors are providing Contractor Control Insurance Programs (CCIPs) to all participants in a construction project. These are insurance policies in which errors & omissions insurance, workers' compensation insurance, commercial general liability insurance, as well as excess, umbrella and other special coverages are wrapped into one insurance program. Some have also been able to wrap in errors and omissions policies for architects, engineers and other design professionals. The developer requires participants such as subcontractors and design professionals to reduce their price by eliminating all of their insurance costs in exchange for owner-provided coverage.[11] The owner expects to save money by discount-purchasing of insurance and by avoiding contractor markups on insurance costs. Also, a single insurance carrier on the risk for claims can result in more efficient and less expensive claim resolution.[12] A CCIP is essentially the same as an OCIP except that the controlling party is the general contractor rather than the owner. General contractors may prefer CCIPs because they enable them to be in a better position to control the procurement process by controlling the subcontracting process.[13]

The Insurance Procurement Process — Price vs. Coverage and the Importance of Careful Negotiation

According to Mr. Daoussis, even though developers are paying seven digit premiums for their policies, many of them are not getting the coverage they think they are getting. In his presentation, Mr. Daoussis explained that this is primarily due to the inefficiencies and inequities of the insurance procurement process that raise significant barriers against proper negotiation of insurance policies.

It is imperative that those who are procuring insurance for condominium conversions employ insurance agents/brokers with expertise and experience with condominium projects, with a long track record on coverage issues, and with in-house counsel that are able to negotiate terms and conditions of coverage. Agents/brokers are those who gather underwriting information from insurance purchasers and market accounts to insurance carriers or wholesalers. They also service the accounts after coverage is placed and provide technical expertise.

Insurance coverage negotiations would be most effective if agents/brokers could negotiate directly with carriers. However, agents/brokers often have to deal with at least two intermediaries. Certain insurance carriers can only be accessed through certain types of wholesalers/E&S brokers. Wholesalers/E&S brokers work with licensed insurance agents and brokers to place difficult coverages or classes of business with excess and surplus lines insurance companies, which are non-admitted companies and whose policies are not filed with the California Department of Insurance. Certain other carriers require a specific type of wholesale broker or Managing General Agents (MGAs), who have authority and responsibility to underwrite on behalf of the insurance company.

Because the insurance procurement process often involves several intermediaries, miscommunication is prevalent. The underwriter may not accurately understand the kind of coverage the purchaser is seeking as information travels through several intermediaries, and the information coming back from the ultimate carrier to the potential insured may not adequately communicate what exclusions the ultimate carrier include in their policies. Underwriters hardly explain what their policies cover and the insured parties tend to find out the scope of their coverage by the time claims arise. For example, when an insurance broker informs the developer that he was able to get design professional liability insurance, a developer must carefully read, negotiate and confirm at the time the insurance policy is negotiated and purchased whether such policy includes coverage for professional liability. Although underwriters often represent that they were able to procure insurance for architects and engineers, the text of the endorsement may limit coverage to an architect's slip and fall incident at the construction site but exclude errors and omissions liability for a stairwell that was incorrectly designed by such architect.

Those procuring insurance should also negotiate at the outset the agent/broker's fee based on services provided. An agent/broker can be compensated more if he provides an in-house tracking system for subcontractors to make sure each of them is properly enrolled in the wrap up policy. This can prevent the insurance company from claiming that damage done by a subtrade is not covered because such subtrade is not properly enrolled. In addition, in the fee negotiations, one should remember that where the ultimate carrier does not underwrite its own policies and the procurement process involves multiple intermediaries, each intermediary stands to make underwriting profit and the ultimate purchaser tends to pay a higher premium.

Lastly, most agents/brokers sell price because they are compensated on premium. Mr. Daoussis emphasized that it is imperative that one buys both price and coverage. Good underwriters can hopefully offer both. "Price is important the day you buy, coverage is important every other day."

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11 Bradford A. Nilsson, *Owner Controlled Insurance Programs (OCIPs): Why Owners Like Them and Why Contractors May Not*, Jul. 14, 2003, **http://www.constructionweblinks.com/Resources/Industry_Reports__Newsletters/July_14_2003/ocip.htm**.

12 Id.

13 Richard Resnick, *Have You Thought About a Contractor Controlled Insurance Program?*, Jan 2005, **http://www.irmi.com/Expert/Articles/2005/Resnick01.aspx**.

Perspectives on Negotiation, Allocation and Assumption of Risk in Real Estate Deals Today

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by: Stacy Mau, Esq.

The breakout session at the Crocker Symposium entitled "Perspectives on Negotiation, Allocation and Assumption of Risk in Real Estate Deals Today" was moderated by Eric T. Schake, the Global Real Estate Practice Leader for Marsh, with panelists J. Dean Heller, a partner at Sonnenschein, Nath & Rosenthal, and Michael Silva, a Senior Managing Associate at Kroll, Schiff & Associates. The panelists provided an overview of the risks involved in various real estate transactions and different perspectives on the allocation of risks between each party.

Risks in real estate transactions are allocated to the parties by statute or legal principles absent an agreement to the contrary. However, because applicable laws and legal principles grant parties considerable flexibility in allocating risks by agreement, the negotiation of risk allocation is an essential component of every real estate transaction.

There are numerous risks involved in real estate transactions. These risks fall into the following categories: (i) party risks, (ii) property risks, (iii) fiscal risks, (iv) market risks, and (v) exogenous risks.

(i) Party risks involve the other party's credit, competence, character, and commitment to the deal. The allocation of party risks is generally difficult to negotiate because they are inherent in the parties themselves, though the credit risk can be mitigated by requiring guaranties, letters of credit, deposits and holdbacks and other forms of collateral.

(ii) Property risks involve physical defects, code violations, environmental hazards, zoning, title, and endorsements. Parties use representations and due diligence both to identify and to allocate or mitigate property risks. Presumably, much of this information regarding property risks is already known to a seller or borrower, but in the current market for commercial real estate sellers strongly resist providing representations or warranties, forcing buyers to assume property risks that they are unable to identify through due diligence.

(iii) Fiscal risks involve the quality and credit of tenants, tenant turnover, expenses associated with the property, and taxes. For the most part, fiscal risks are assumed by buyers of commercial real property, who depend largely on their own pre-purchase investigations to identify and assess these risks. In some cases, a specific tenant risk— such as a major tenant in bankruptcy— may be at least partly allocated to the seller through such devices as a holdback of some portion of the purchase price to cover the potential rent loss.

(iv) Market risks involve competition, location, and supply and demand. Market risks are not easily allocated because these risks are hard to anticipate. In any event, they are almost always regarded as a buyer risk in purchase transactions.

(v) Exogenous risks involve fluctuation in interest rates or tax rates, casualties, and changes to applicable laws. Like market and party risks, exogenous risks are difficult to foresee and are regarded properly as the buyer's risk.

Considerable time is spent during the negotiation process to allocate risks — particularly property risks— between the parties. However, in the current landscape of commercial real estate transactions, sellers of commercial real estate are becoming increasingly aggressive in attempting to fashion commercial real estate sales as *caveat emptor*, while buyers have become more willing to assume the risks of the transaction. This phenomenon is the result of a strong sellers' market, with demand for commercial real estate investments greatly exceeding the actual supply of investment-grade properties. Nonetheless, there are several ways buyers can protect themselves against the risks they are assuming.

One way for the buyer to protect themselves from risks is to diversify their real estate investments. By acquiring portfolios of properties, the assumed risks and costs of such risks will be spread out among all the properties.

Another way buyers can protect themselves is through due diligence. A thorough investigation of the property will allow a buyer to identify and evaluate the risks associated with the property. If possible, some due diligence should be done prior to entering into negotiations with the other party so that the purchase price properly reflects the risks associated with the property. One often overlooked advantage to sellers in conducting their own pre-market due diligence and making sure that the offering materials present the property "warts and all," is that prospective buyers in the current market are more likely to minimize the "price" of risks identified in the course of the bidding for the property, compared to those discovered during due diligence.

Insurance is a traditional way that buyers have protected themselves from certain types risks. Available types of "transaction" insurance include title and environmental hazard.

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Regulating and Subsidizing Superstores: The Big-Box Paradox

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Constitutional Considerations

Use of land use regulations and environmental review to stop or discourage legitimate business activity is unconstitutional. Case law indicates that zoning ordinances cannot be used to regulate economic activity. Such land use regulations or ordinances also raise equal protection and due process issues. Proponents of Wal-Mart suggest that its stores can not be distinguished from other similar retail stores including membership stores and free standing grocery stores in terms of trip requirements, traffic and environmental effects. In other words, Wal-Mart argues that there is no legitimate land use issue that makes Wal-Mart distinct from other large format retail stores.

Advocates of the ordinances proffer that the city is using its legitimate police powers to regulate noxious land use development (e.g. adult clubs, casinos, gas stations). Singling out Wal-Mart is justified because of the big box stores unique impacts on communities. Substantial evidence supports a rational basis that there are differences between the numbers of trips to grocery stores as compared to big box retail.

The unsettled legal considerations have caused both sides of the debate to attempt to circumvent the legal process. Both have now turned to the legislative process and are seeking to fund campaigns and elect representatives to local councils or commissions that are receptive to their views. Many agree that the legislature is the proper forum for this type of debate. Perhaps in this way, all issues and interests will be vetted and a reasonable solution obtained.

Recent Tax Developments Affecting Real Estate

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by Diane Hvolka

American Jobs Creation Act of 2004 — If Commercial Property Owners and Tenants Can Place Certain Improvements into Service Before 12/31/05, They Can Benefit From a Shorter Depreciation Period

Leasehold Improvements

Normally, leasehold improvements are depreciable over a 39-year life, the same as other commercial building depreciation. However, on October 22, 2004, President Bush signed the American Jobs Creation Act (the "**Act**") into law. The Act provides, among other things, that for a temporary window — from the date the Act was enacted through December 31, 2005 — "qualified leasehold improvements" may be depreciated using the straight line method over a significantly shorter 15-year period. "Qualified Leasehold Improvements" are defined in Section 168(k)(3) of the Internal Revenue Code of 1986 (the "**Code**") as follows: (i) the improvement is made under or pursuant to a lease (or a commitment to enter into a lease) by the tenant, subtenant or landlord; (ii) the lease is not between related persons; (iii) the leased premises are occupied exclusively by the tenant or subtenant; (iv) the improvement is a structural component of a building (as defined under Section 1250 of the Code); and (v) the improvement is placed into service more than there years after the date that the building was first placed into service. The definition of "Qualified Leasehold Improvements" specifically excludes (i) the enlargement of a building; (ii) elevators and escalators; (iii) structural components that benefit a common area; and (iv) internal structural framework.

The following example, which uses the required straight line method of depreciation, shows how a commercial landlord could benefit from the Act (note that improvements to residential property do not qualify for the 15-year depreciation period). Assume a landlord and tenant entered into a lease, with the landlord agreeing to construct $500,000 worth of qualified improvements in the premises. If the landlord completed construction of the improvements and the tenant moved in by January 1, 2005, the landlord would be entitled to 11.5 months of depreciation in 2005 (under the "mid-month convention," a half-month's depreciation is claimed for the month that the asset is placed in service). Under the Act, the landlord would be entitled to a depreciation deduction of $31,944.44 in 2005 and a depreciation deduction of $33,333.33 thereafter ($500,000 divided by 15 years). Under the former tax law (which will revive on January 1, 2006), the landlord would be entitled to a depreciation deduction of only $12,286.32 in 2005 and a depreciation deduction of $12,820.51 thereafter ($500,000 divided by 39 years).

Unfortunately, qualified improvements placed in service by the original landlord generally cannot be treated as qualified improvements by subsequent owners unless one of the following exceptions (set forth in Code Section 168(e)(6)(B)) applies: (i) the leasehold improvement is acquired from the original landlord by reason of the landlord's death (note that a transfer by gift does not appear to be an excepted transfer); (ii) certain corporate liquidations and reorganizations to which Code Section 381(a) applies; (iii) a mere change in form of doing business as long as the original landlord retains a substantial interest in the trade or business; (iv) a carryover basis transaction such as a like kind exchange under Section 1031, an involuntary conversion under Section 1033 or the reacquisition of property in foreclosure under Section 1038 (to the extent that the property reacquired has a carryover basis); or (v) certain other carryover basis transactions, including complete corporate liquidations under Section 332 of the Code.

On March 15, 2005, Senator Gaylord Conrad [D-ND] introduced S. 621, a bill which, if passed, will permanently extend the 15-year depreciation period for qualified leasehold improvements by eliminating the sunset provision from the Code.

Qualified Restaurant Property

The Act also provides for a 15-year depreciation period (using the straight line method) for "Qualified Restaurant Property," the definition of which is generally much broader than qualified leasehold improvements and includes items not included in qualified leasehold improvements. However, if the restaurant is not located in a stand-alone building, the restaurant operator may need to rely on the qualified leasehold improvement definition to take advantage of the 15-year depreciation period. This is because improvements will not qualify for the accelerated depreciation period unless more than 50% of the building's square footage is devoted to the preparation of meals and seating for on-premises consumption of prepared meals.

Examples of qualified restaurant property include electrical system components not dedicated to specified equipment, most lighting, elevators and escalators, fire protection systems, floor covering (other than carpet), HVAC (unless dedicated solely to kitchen area), most plumbing, restroom accessories, platforms, walls, permanent wall coverings and roofs. "Land Improvements," which include items such as a detached sign on a separate concrete foundation, sidewalks, parking lots and landscaping, that are already depreciable over a 15-year life do not constitute qualified restaurant property.

In order to qualify for the accelerated depreciation period, the restaurant building must have been originally placed in service at least there years before the improvement was placed in service. However, the building need not have previously been a restaurant facility. Thus, a restaurant operator could purchase a building that has been in service for at least three years and convert the building to a restaurant and have remodeling costs qualify. Furthermore, unlike with leasehold improvements, the building need not have been owned by the current owner when the improvement was originally placed in service (in other words, qualified restaurant property retains its status upon sale or other disposition and the new owner can also depreciate the property over 15 years).

Proposition 13 Challenge Fails in California Appellate Court: Appellate Court Holds that Annual 2% Limit on Increases in Assessed Value Applies Only to Increases in the Base Year Value

Under California's Proposition 13, enacted in June of 1978, when real property is purchased, improved, or undergoes a "change in ownership", the assessor will establish a base year value for the property. Such base year value is adjusted upwards each year by the lower of the prior year's inflation factor or 2%. The base year value is the maximum assessable value until another purchase, change of ownership or improvement. In

order to address the situation where property goes down in value (which was omitted in the original Proposition 13), Proposition 8 was enacted in November of 1978 to allow assessors to reduce assessments in situations where property value had declined.

In *County of Orange v. Bezaire*, 117 Cal. App. 4th 121 (2004), the owners of a home in Orange County, California applied to the county reassessment appeals board for a reduction in their 1998 assessment. The homeowners had purchased their home in 1995 for $330,000, which was thus the enrolled value for 1996. *Id.* at 125. In 1997, the home did not gain in value and was enrolled again at $330,000. *Id.* However, in 1998 property values did better and the assessor increased the enrolled value to $343,332, which is 2% for each year for the two years, compounded, based on the original $330,000 purchase price. *Id.* The amount of $343,332 is actually 4% more than the previous year's assessment of $330,000, which led the homeowners to apply for an assessment reduction on the basis that the assessment should be reduced to an amount 2% over the prior years' amount, or $333,366. *Id.*

The California court of appeals held that in assessing real property that did not gain in value in 1997, but did gain in value in 1998, the assessor was correct in increasing the property tax by 2% for each of the two prior years, not just by 2% of the last year's value. *Id.* To reach this conclusion, the court looked at the text of Proposition 13 (as modified by Proposition 8), the "technical structure of Proposition 13" and historical evidence of the intent of the drafters of Proposition 13 (and Proposition 8). *Id.* The court determined that the intent of the drafters of the inflation cap was to have it track the base, and not any intervening year when there is a downward reassessment. *Id.* at 133. The court noted that Proposition 8 was originally enacted to deal with the plight of victims of a major fire in Santa Barbara in 1977, since under Proposition 13 as originally written, the fire victims would have been stuck paying property taxes on 1975-1976 values, when there were homes on their land. *Id.* at 134. The ballot argument for Proposition 8 thus did not specifically mention declines in property value due to deflation, but rather specifically focused on disaster. The court of appeals reasoned that Proposition 8 was intended to make any decline in the base value *short term*, not long-term, meaning that the inflation cap should be figured on the original base value, not any temporarily reduced base. *Id.* at 135. Hence, the court's holding that an assessor may change a property's value each year to the lower of its current market value or the upper limit of value, in which case the increase may end up being more than 2%.

Note that one of the homeowners in the case plans to ask the California Supreme Court to review the appellate court's decision.

Summaries of Other Recent California Property Tax Developments

A. Base-Year Value Appeals — Two Year Period

Assembly Bill 2857, which was signed into law on September 24, 2004, provides that when an assessment appeal application on a base year value is not timely heard and decided within two years of filing an appeal, the taxpayer's opinion of value will become the taxable value of the property *until the appeal is decided*. The bill addresses a recent court case, *FlightSafety International, Inc. v. Los Angeles County Assessment Appeals Board*, 105 Cal.App.4th 620, in which the assessment appeals board failed to hear a petition within two years for the 1992 year. A court ordered the County to enter the zero value from the petition on the assessment roll, which the appeals board finally did in 1998. The county only changed the 1992 roll. Flightsafety appealed, and the appellate court directed the county to leave the 1992 value on the roll for all years until 1998.

Under Assembly Bill 2857, taxpayers who appeal the base-year value of their property will have their opinions of value entered on the tax rolls if an assessment appeals board fails to act on the appeal in a timely manner (i.e., within two years), and the taxpayer's opinion will remain on the roll until the board makes a final determination on the application. The legislative intent is to provide fairness to taxpayers who appeal in good faith but do not receive a timely decision from the assessment appeals board. Assembly Bill 2857 applies only to requests for a reduction in the base year value of an assessment filed pursuant to Section 80(a) of the California Revenue and Taxation Code, so for other types of appeals (i.e., decline in value, personal property, etc.) the taxpayer's opinion of value will only be enrolled for the tax year covered by the application.

B. No Reassessment for Real Property Acquired to Replace Property Taken by Governmental Action or Eminent Domain Proceedings

California Code of Regulations Rule 462.500, which became effective on December 18, 2004, provides that acquisition of comparable replacement real property does not trigger reassessment under Proposition 13 if the person acquiring the property was displaced by eminent domain proceedings, acquisition by a public entity, or governmental action resulting in a judgment of inverse condemnation. Replacement real property is deemed comparable if similar in size, utility, and function. Size is associated with value, not physical characteristics, and two properties are similar in size if the full cash value of the replacement property does not exceed 20% of the award or purchase price paid for the property taken. The rule associates utility and function with use, delineates three specific categories of use (Category A – single-family residence or duplex; Category B – commercial, investment income or vacant property; and Category C – agricultural property), and provides examples.

C. State and Federal Low Income Housing Credits not Considered Income

Assembly Bill 2846, signed into law in 2004, prohibits the assessor, when appraising property under the income method of appraisal, from considering *as income* the benefit of federal and state low-income housing tax credits.

The federal Low Income Housing Tax Credit program is intended to provide incentives for private investment in housing for low-income families. Under the program, low-income housing projects developed after 1986 may be awarded tax credits in amounts up to 9% of the development costs, excluding land. Shortly after the federal program was enacted, the California Legislature authorized a state low income housing tax credit to augment the federal program. The state low income housing tax credit program is codified in several California statutes and accompanying regulations. The state program does not stand alone; rather, it is designed to supplement the federal tax credit program, with state tax credits used to bridge a project's remaining financing gap. State tax credits are available only to projects that also have received federal tax credits. Prior to enactment of AB 2846, California law was silent on the valuation of such projects. In practice, some assessors are

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Dispatches from the Retail Wars: A Conversation with Rick Caruso

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by Jeffrey N. Brown *Morgan Lewis & Bockius LLP*

Rick J. Caruso is the founder and Chief Executive Officer of Caruso Affiliated, a developer of outdoor retail and entertainment environments. Mr. Caruso's projects include The Encino Marketplace, The Promenade at Westlake, The Commons at Calabasas, and The Grove. He was interviewed by Linda J. Bozung, a partner at DLA Piper Rudnick Gray Cary US LLP. Ms. Bozung's practice focuses on land use planning, zoning and entitlement acquisition and protection; she is outside counsel to Mr. Caruso on various projects. Ms. Bozung and the audience asked Mr. Caruso questions, in an interview style, concerning the success of his projects, his views about the future of indoor malls, and challenges by competitors in the entitlement process. Mr. Caruso's answers were often humorous and provocative.

Mr. Caruso related that he believed that his projects were successful, in large part, because they provide a format that is natural for people. He said that people want a clean and safe environment to which to take their families. As the world becomes more complicated, people have less time to spend on shopping and recreation, Mr. Caruso said, so his outdoor retail centers provide a place to "hang out." While the mother, who Mr. Caruso stated is the primary shopper, spends time at the various retailers, the father and the children have the opportunity to go to a movie, dine, and "people watch." According to Mr. Caruso, instead of the father and children pushing to leave the center to go home, they like the environment, leaving the "primary shopper" able to spend more time and money at the location. An added benefit for his centers are that they are outdoors. Mr. Caruso stated that making the retail environment outdoors provides a sense of the family being on vacation. And the fact that the outdoor retailers may be in less-than-fair climate locations is not a determining factor. Mr. Caruso pointed out that some of the best retailers are located in outdoor areas which are inclement, such as New York's Fifth Avenue and Paris' Champs-Elysees.

Mr. Caruso said he has a great team of people working with him, and that he does most everything "in-house." He uses designers who are not familiar with retail so that they provide an uncommon look for his centers, and he visits "great streets" in the United States and around the world so that he can emulate them. As an example, he said that he hired a Hollywood set designer for the Calabasas project. Mr. Caruso stated he does not want customers to feel that they are in the same project at different locations; he wants each outdoor center to have an individual culture and varied characteristics. Therefore, he said he tries to design his centers as resorts, because when people are on vacation, they spend more and they eat more, Mr. Caruso stated. He said that outdoor retail centers average sales of three times that of indoor malls.

When asked how closed mall owners will compete in the future, Mr. Caruso said they will need to reinvent themselves to provide the tenants and the customers what they want. He said that tenants now want to be on streets, in outdoor settings. He called this a "sea change in the industry." He said that last year, outdoor retail centers accounted for approximately 29 million square feet of new construction versus three indoor malls. Mr. Caruso said he anticipates that Caruso Affiliated will spend more than $1 billion over the next five years in the development of outdoor retail projects.

Mr. Caruso described the "battles" he has had and is having with his competitors. He stated that because several of the indoor malls are owned by REITs, which are earnings-driven and do not develop new projects, he said, his competition in a location brings down tenant rental. Therefore, he said, it is less expensive for existing landlords to try to stop his developments through entitlement challenges than to reinvent themselves. He said the competitors have no "down side" in the process; if the competitors are successful, they stop him from entering the market, and if they are not successful, they are not required to pay for Mr. Caruso's attorneys' fees incurred in overcoming the challenge. "It's all about earnings," Mr. Caruso stated.

When asked if he planned to develop an outdoor center in Downtown Los Angeles, Mr. Caruso said that he has passed on the opportunity for now. He said that he would wait to see if enough people will travel to Downtown to make a project profitable. He said that he was neither a "pioneer" nor a "settler," and that he would wait to see the success of others' projects before deciding whether to attempt his own.

Asked what he considers the most important factors in his determination of the location of a future project, he answered education, demographics, and density, with the first the most important because, even in a down market, educated people spend money.

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III. Conclusion

All parties involved in the conversion market are trading risk for price. The developer is willing to pay the general contractor more for better indemnification clauses in its contracts. The developer and contractors are paying higher insurance premiums for better coverage or get better pricing by accepting exclusions for acceptable levels of risk. Developers are getting better pricing from subcontractors by purchasing wrap up policies and are minimizing the number of potential claims and finger pointing by employing the design-build structure.

As the mechanisms highlighted by the panel reflect, despite risks inherent in condominium conversions, the conversion industry has been busy and able to respond to market demand by making a concerted effort to, among other things, (1) build quality products, (2) offer excellent follow up warranty services, (3) apply quality control mechanisms, (4) properly allocate risks, (4) obtain appropriate levels of insurance coverage through careful negotiation.

Lydia Lee, Esq. is a real estate associate in the law firm of Baker & Hostetler LLP.

Recent Tax Developments Affecting Real Estate

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not aware that low-income housing projects are receiving tax credits, and therefore do not capitalize the income from tax credits. Others value the projects by (1) capitalizing the project's restricted income and (2) adding the present value of the remaining tax credits to the capitalized restricted income value. AB 2846 clarifies the procedure for valuing properties financed with low-income housing tax credits, by providing that the benefit of the tax credits is not to be considered income under the income approach to value.

This article was based on a program given at the April 21, 2005 Benjamin S. Crocker Symposium by Marcy Jo Mandel, Deputy State Controller, Taxation, State of California; James de Bree, Jr. of Deloitte Tax LLP; and Donald J. Winkler, JD, CPA of Green Hasson & Janks, LLP.

Mezzanine and Securitized Financing: What Every Borrower Needs to Know

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By Nancy M. Bou

The breakout session at the Crocker Symposium on Mezzanine and Securitized Financing was moderated by Glenn Sonnenberg, President of Legg Mason Real Estate Investors, with panelists Scott Davidson, Head of Structured Finance and Real Estate at Spectrum Investment Management, and Michael Gambro, Partner at Cadwalader, Wickersham & Taft LLP. The panelists provided an overview of mezzanine financing, its advantages and disadvantages, an overview of securitized financing, its advantages and disadvantages, and wrapped up with a discussion of which type of financing is appropriate in a given set of circumstances.

Mezzanine Financing

With mezzanine financing, the owner of the real property is the single purpose entity ("SPE") borrower (the "Property Owner SPE") of a loan secured by a first mortgage on the property. The Property Owner SPE is owned one hundred percent by another SPE (the "Mezz SPE"), which is the borrower from the mezzanine lender, and the ownership interest in the Property Owner SPE serves as the security. The principals of the Mezz SPE are the individuals executing the non-recourse carve-outs. The first mortgagee and the mezzanine lender enter into an inter-creditor agreement that memorializes their relationship and the mezzanine lender's cure rights. Mezzanine loans typically have a term of 18 months to five years and provide a loan to value ratio ("LTV") of 70% to 90%. The mezzanine lender, which holds as its collateral the first lien on the equity interest in the Mezz SPE, has the right to foreclose but this rarely happens in the marketplace.

The primary advantages to mezzanine financing include:

- Increased leverage, up to 90% LTV;
- Allows operator to reposition asset and increase net operating income ("NOI");
- Fewer disclosure requirements than securitized financing; and
- Provides flexibility to sell or refinance anytime over the next five years.

The major disadvantages are:

- Developer loses some control over major capital events;
- More expensive form of capital, potentially requires capital appreciation;
- Too expensive for smaller transactions; and
- Highly complicated structure.

Securitized Financing

Securitized financing, on the other hand, provides loans to owners of real property, which is secured by a first mortgage on the property. The originator of the loan deposits the loan with a special purpose vehicle ("SPV") and subsequently sells securities to investors. The SPV conveys the mortgage into a trust that originates securities. The Trustee contracts with a master servicer, who in turn contracts with a primary servicer, who then collects money each month and remits it to the Trustee. The Trustee apportions the remitted funds among the investors according to their agreed priorities. Securitized loans typically have a term of seven to ten years and provide an LTV of up to 75%.

The primary advantages to conduit loans include:

- Higher current proceeds than many other alternatives;
- Attractive interest rates;
- Efficient and standardized underwriting and documentation process;
- Often available to lower quality assets and assets in smaller markets; and
- Longer term loans, typically ten years.

The major disadvantages are:

- Rigidity of the loan documentation leaves little room for negotiation;
- Loan may be prepaid without penalty only within months of maturity;
- No "relationship lending" (the party originating the loan is not the lender during the term of the loan);
- Significant defeasance penalties (utilization of defeasance is rare due to its complex and expensive nature);
- Little flexibility for modifications, extensions, and other changes during the term of the loan; and
- Extensive disclosure requirements.

Mezzanine Financing v. Securitized Financing

The decision of whether to use mezzanine financing or securitized financing should be based on the plans for the underlying property. Both types of financing are methods by which the borrower can maximize proceeds but are best used in different circumstances. If it is a value play and requires additional investment to increase the property's NOI, then the Mezzanine financing will be the better option. Mezzanine financing is also the better option if the property is transitional and there may be a need for amendments or restructuring during the deal. Finally, mezzanine financing is the better option if the borrower intends to sell or refinance the property in the next three to five years. Securitized financing tends to be the better option for stabilized assets where there is little expectation of significant improvement in the short to medium term. Securitized financing provides lower interest rates but requires increased disclosure and regulations which limit the borrower's flexibility when it comes to exiting the transaction.

There are also times when borrower's look to layer both a conduit loan and mezzanine piece of financing into the capital structure. If you want to have both types of capital, it is best to obtain them at the same time. It is more common for people to try to add the mezzanine financing after a conduit loan is already in place but this raises several difficulties. Lawyers try to build into the documents the ability to have additional indebtedness but there is usually a provision in the documents which prohibits transfers. The mezzanine lender's foreclosure constitutes a transfer which is not allowed under the conduit loan documents. This specific provision is the one most commonly violated. An alternative the panelists touched on at the symposium is utilizing synthetic mezzanine financing which effectively splits the loan into an A part and B part upon securitization, with more flexibility for paying back the loan on the A portion.

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Cutting-Edge Lease Negotiations:

Resolving the Battles Between Landlords and Tenants Without Starting a War

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By: Stacy Mau, Esq.

The breakout session at the Crocker Symposium entitled "Cutting-Edge Lease Negotiations: Resolving the Battles Between Landlords and Tenants Without Starting a War" was moderated by Susan Taylor, Managing Counsel of Equity Office Properties, with panelists Anthony Manos, Executive Vice President of Commercial and Mixed Use Development for Westfield Corporation, and Anton Nastis, partner at Allen Matkins Leck Gamble & Mallory providing the landlords' perspective, and panelists Mark Sullivan, Executive Vice President and Branch Manager of Studley, and Michael Meyer, managing partner at DLA Piper Rudnick Gray Cary providing the tenants' perspective. The panelists provided an overview of lease negotiations and also provided insight as to the landlords' and tenants' perspective on various lease issues.

Lease negotiations are distinct from other real estate negotiations because in lease negotiations, the parties will remain in a long-term relationship that is dictated by the product of the negotiation. Therefore, it is important that during the negotiation process, both landlords and tenants be cognizant of the market conditions and realistic in their expectations of each other.

One way to facilitate the negotiation process is for tenants and landlords to be candid with each other with regard to issues that could ultimately cause the transaction to fail. In general, the Request for Proposal ("RFP") and Letter of Intent ("LOI") stage of lease negotiations is when tenants are best able to obtain concessions to their demands. Therefore, at the RFP stage, tenants should identify those issues which could be potential deal breakers, and include such information in the RFP. By identifying all deal-breaker issues in the RFP, potential landlords will be on notice of such issues immediately, and can decide whether they are amenable to granting tenants' demands prior to entering into negotiations. This allows for candid negotiations on the important issues because if a landlord would not be amenable to the tenant's demands, the parties will not expend time and energy on negotiating a lease that ultimately is not executed. Further, all such hot issues should be addressed in the LOI. The LOI should also address all the major economics of the deal, but be fungible enough to allow for further negotiations.

Another way to facilitate the negotiation process is to be aware of the other party's perspective on the issue. The following are tenant's and landlord's perspectives on various issues:

Free Rent/Inducement

Often times, as an inducement to enter into the tenancy, a lease will provide the tenant with a certain number of months free rent. The default provision in most leases require that tenants refund landlords the amortized amount of free rent in the event of a tenant default.

Tenant's perspective: The lease should not require tenants to reimburse the free rent because this would provide landlords with a windfall. The term free rent is a misnomer because landlords consider all the economics of the deal, including any free rent or tenant improvement allowance, in determining the rent amount. Therefore, the negotiated rent already includes any inducement the tenant received to enter into the rent. Because all leases provide landlords with the remedy of collecting all rent due on the lease in the event of a tenant's default, landlords are already recovering all the amounts they expected to receive when they entered into the lease. To allow landlords to recover the free rent or other inducements in addition to all rent due would result in a windfall for landlords.

Landlord's perspective: The reimbursement of free rent provision only comes into play if the tenant defaults on the lease. If a tenant defaults on a lease, they are the "bad actor" and therefore should be responsible for the consequences of their actions.

Tax Protection

Proposition 13 allows a property owner to pay taxes based on the purchase price of the building as opposed to the current assessed value of the property. However, any time the property changes ownership, taxes are reassessed based on the purchase price of the building, and the reassessed taxes are usually much higher than the current tax amount. Tenants will often seek Proposition 13 protection, providing tenants protection from any tax increase based on a sale, change of ownership or refinancing of the building.

Tenant's perspective: Tenants will always seek to have Proposition 13 protection. However, the larger the leased premise, the more the tenant is affected by the changes in taxes. Tenants who lease an entire floor or more should be entitled to Proposition 13 protection because without the protection, an abrupt change in the tax burden on such tenants could severely impact the tenants' financials.

Landlord's perspective: There is an inverse correlation between when landlords are amenable to granting Proposition 13 protection and when tenants desire Proposition 13 protection. When the leased premise comprises only a small portion of the building, granting Proposition 13 protection would only minimally affect the landlord because the tenant of a smaller leased premise is responsible for only its small portion of the building's taxes. Conversely, when the leased premise comprises a majority of the building, Proposition 13 protection will have a large impact on the landlord. However, the larger the leased premises, the more the tenant feels entitled to Proposition 13 protection.

Recognition Statements for Assignees and Subtenants

Recognition statements are an agreement in which the landlord agrees to recognize any assignment or sublease as a direct lease with the landlord in the event that the tenant defaults under the master lease.

Tenant's perspective: For tenants, recognition statements are as important as subordination non-disclosure attornment agreements are for landlords. Assigning or subletting a lease is becoming increasingly important issue as more and more tenants are not staying in their premises for the entire lease term. Tenants ability to assign or sublet is hindered if a landlord does not agree to provide a recognition statement to the assignee or subtenant. Landlords should be amenable to providing recognition statements if the transferee occupies a certain amount of square feet, as negotiated by the landlord and tenant.

Landlord's perspective: Landlords do not want to recognize any transferee that does not meet the same financials as the original tenant. In addition, recognition statements are problematic because the transferee could be subleasing a portion of the premises that makes it difficult for the landlord to relet the remaining unoccupied portion of the premises. For instance, the transferee could be subleasing the middle floor

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Resolving the Battles Between Landlords and Tenants Without Starting a War

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of five floors, making it impossible for the landlord to relet contiguous floors to another tenant. By granting a recognition statement, the landlord would not have as much flexibility in the event the original tenant defaults under the lease.

Overall, as with all negotiations, the resolution of many issues will simply be based on the market. However, because the parties will be in a long-standing relationship after the lease negotiation, the best way to avoid contentious negotiations is to live by the oft-quoted golden rule: To treat others the way you would like to be treated.

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A Mechanic's Lien Primer

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4. A Notice of Non-Responsibility protects the owner from liens, on anything except a lease.

IV. Foreclosing the Lien

California Civil Code § 3144 requires a claimant to timely file a complaint to foreclose the lien within 90 days after date of recordation of lien, in the proper court unless a Notice of Credit (no longer than one year from lien date) is granted by the owner and recorded with the county recorders office. If the lien foreclosure action is not done within this 90 day period the lien rights on the project can expire forever.

Issues to Remember

1. The claimant has 90 days from the lien recording date to begin foreclosure.

V. Owners Protections

An owner may post a Notice of Non-Responsibility in the event that the person ordering the work is not the owner. This usually occurs when a tenant finishes or modifies the inside of a building. The notice of Non-Responsibility protects the owner from any liens on the property, which means no one on the job has lien rights on the land but may have some lien rights against the value of the lease. California Civil Code §3094 requires that the owner physically post this notice on the jobsite, and record it with the county recorder, within 10 days of learning of the project. Note that the posting is not related to the start of work, it is based upon the time the owner discovers the work is being done.

The owner can also protect itself through strong disbursement controls and joint checks. The owner should require waivers and releases following the statutory forms in California Civil Code §3262 following each payment during the progress of the project.

Mechanics' liens are an extremely effective mechanism for claimants to pursue payment for monies owed by clouding the title and securing interest in the property to fulfill the debt. The law does allow property owners to "Bond around the lien" by placing a bond of 125% of the lien amount with the county recorder. The property can then be sold and the bond remains to satisfy the claim of lien.

Issues to Remember

1. A Notice of Non-Responsibility protects the owner from liens, on anything except a lease.
2. An owner can require waivers and releases throughout the course of the project.
3. An owner can bond around the lien for 1½ times the claim to maintain a clear title for their property.

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