(CDLAC Procedures continued from page 9)

these 12 projects had been evaluated under CDLAC's 2003 procedures, 8 of the 12 projects would not have reached this year's 70-point threshold and would have had to wait to compete for remaining allocation after the third round. Given the anticipated demand in the third round of 2003, those eight projects possibly would not receive allocation at all in 2003. The lack of available allocation from the General Pool and an increased point threshold will lead to stiff competition among mixed-income projects.

Despite the annual increase in bond volume capacity, all signs indicate that the remaining two allocation rounds will be highly competitive, particularly the third round.

Conclusion

The ramifications of CDLAC's adjustments to its allocation process will emerge as the year continues. The deadline for qualified residential rental applications for the first round of allocation expired on January 15, 2003. Consequently, multifamily projects seeking tax-exempt bond allocation will need to compete in the remaining two rounds. Despite the annual increase in bond volume capacity, all signs indicate that the remaining two allocation rounds will be highly competitive, particularly the third round. The adjustments adopted by CDLAC demand that projects maximize points, through increased affordability or other CDLAC-evaluated criteria, or risk not receiving allocation. Careful planning and strategy prior to application to CDLAC will prove critical for developers and issuers involved in multifamily housing bond financing.

Tuan A. Pham is an Associate in the Century City office and may be reached via email at tpham@pillsburywinthrop.com or by phone at (310) 203-1124.

(Preservation continued from page 7)

Additional Restrictions for Additional Subsidies

Because public housing agencies want to prevent the displacement of low-income tenants and encourage the preservation of affordable housing units within their jurisdictions, many agencies will offer additional subsidies or financial assistance to the existing owner or to a new developer of the project if the affordability of the development is threatened. The additional subsidies or financing, however, often come at the price of additional restrictions on the use and operation of the project. When allocating funds to the purchase of an at-risk project, a local jurisdiction will often require restrictions in return to ensure that the project is truly "preserved." These restrictions would include, for example, the following:

- Requiring that the purchaser accept all renewals of any project-based subsidy.
- Requiring that the purchaser accept tenants who receive vouchers.
- Requiring that the period of affordability be extended for an additional 55 years.
- Requiring that the purchaser set up a reserve to subsidize tenant payments if Congress stops renewing Section 8 or stops appropriating funds for vouchers.
- Requiring that rents paid by tenants, particularly in Section 236 projects without Section 8, not increase as a result of the acquisition.
- Requiring that a majority (50-80%) of the cash flow be used to repay the local loan. The purchaser may be receiving substantially higher rents than the pro forma indicates if it continues to receive Section 8 payments. This is because the pro forma shows the "underwriting rents," that is, what will be restricted locally or by TCAC or CDLAC. As Section 8 rents are often substantially higher, the actual cash flow may be very large. The local jurisdiction may share in that cash flow if it is providing funds to the project.

This discussion of issues is not exhaustive, but it provides a glimpse of the complicated nature of preservation deals. Many cities, counties and public housing authorities are providing a range of new tools to developers to encourage the preservation of affordable housing units. Developers confronted with expiring federal or state subsidies can often combine these tools in unique and novel ways. Although the structuring is often complex, affordable housing preservation deals can create valuable opportunities for developers to serve low-income tenants by preserving affordable housing stock.

Gary Downs is a Partner in the San Francisco office and may be reached via email at gdowns@pillsburywinthrop.com or by phone at (415) 983-1835.

Jason Hobson is a Senior Associate in the San Francisco office and may be reached via email at jhobson@pillsburywinthrop.com or by phone at (415) 983-1929.

Pillsbury Winthrop LLP client, MacFarlane Partners, together with CalPERS, developed the Bay Street Apartments, a 264-unit, mixed-income, urban-style apartment complex which will be constructed on the air rights over the retail/entertainment center of the Bay Street commercial, retail master development in Emeryville, California. Pillsbury Winthrop LLP attorneys assisted in the tax-exempt bond financing of the Bay Street Apartments. The $66,715,000 tax-exempt bond financing was the largest bond offering for multifamily housing in the State of California for 2002.

Pillsbury Winthrop LLP attorneys also represented MacFarlane Partners in the financing and construction of the Metropolitan Lofts Apartments, a 264-unit, mixed-income, mixed-use development to be located in Los Angeles, California.

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on affordable housing

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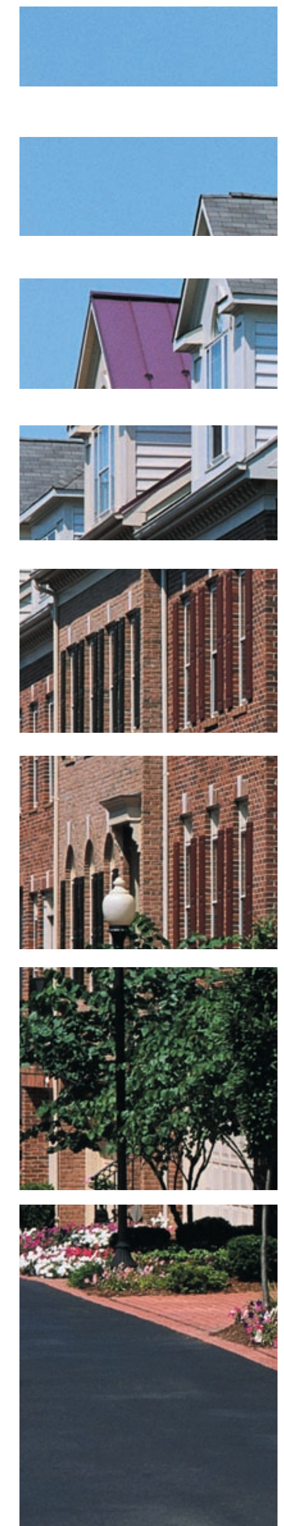


From the Chair

by Mary B. Cranston

The Firm is delighted to publish its second annual Newsletter on Affordable Housing. The affordable housing industry remains as dynamic as ever. Last year, the affordable housing practice group closed more than 50 transactions. The tax-exempt bond financed projects totaled more than $500 million in aggregate principal amount. In addition, the practice team worked on some of the largest multifamily bond transactions in California. A large number of the projects included significant and innovative tax credit financing along with other types of affordable housing subsidies. We plan to continue to devote significant resources to provide valuable and effective service to this industry.

New Markets Tax Credit Update

by Jason A. Hobson

Although interest in the New Markets Tax Credit ("NMTC") program remains high, little has happened within the Community Development Financial Institutions ("CDFI") Fund since it accepted applications for an allocation of NMTCs in August of 2002. In fact, the initial response from investors and syndicators was so overwhelming that the CDFI Fund has modified its expectation for a first-round allocation of NMTCs by several months in order to review the backlog of applications.

(NMTCs continued on page 5)

Federal and State Politicians Inadvertently Squeeze Affordable Housing

by Gary P. Downs

Both the Governor of California and the President of the United States are proposing measures that may drastically affect the funding available for affordable housing. Governor Davis has proposed shifting $500 million of redevelopment funds that benefit affordable housing from local agencies to California's general fund. President Bush is proposing to make corporate dividends tax-exempt, which would likely drive up tax-exempt bond interest rates and chill corporate purchases of tax credits.

The Tax Increment Grab

The California budget crisis has driven Governor Davis to propose shifting $500 million from local redevelopment funds to help fill California's $34 billion budget deficit. Redevelopment agencies are political subdivisions of counties and cities. These agencies receive the tax increment over a baseline year governmental assessment of real property. By law, 20% of the tax increment that is left over after sharing with other taxing agencies must be spent on low- and moderate-income housing. Governor Davis' proposed transfer of $500 million would reduce the low- and moderate-income housing funds by as much as $100 million. Affordable housing developers have traditionally used this money to fill gaps between sources and uses. The withdrawal of this money may threaten the viability of projects needing gap financing, meaning that fewer affordable units will be preserved, built or rehabilitated.

President Bush is proposing to make corporate dividends tax-exempt, which would likely drive up tax-exempt bond interest rates and chill corporate purchases of tax credits.

Governor Davis based his proposal on a state housing report from 1999 that indicated that cities throughout the state had $500 million

(Federal and State Squeeze continued on page 8)

PILLSBURY WINTHROP LLP

on affordable housing

Editor-in-Chief:
Matthew Africa (415) 983-1850
Associate—San Francisco Office
mafrica@pillsburywinthrop.com

Editors:
Gary P. Downs (415) 983-1835
Partner—San Francisco Office
gdowns@pillsburywinthrop.com

Jason Hobson (415) 983-1929
Senior Associate—San Francisco Office
jhobson@pillsburywinthrop.com

Production:
Mary Margaret Healy, Regina Moroney

For further information on Pillsbury Winthrop LLP's Affordable Housing group, please contact:

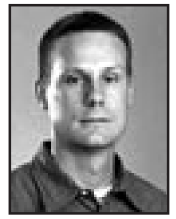
Gary P. Downs (415) 983-1835
Partner—San Francisco Office
gdowns@pillsburywinthrop.com

Lewis G. Feldman (310) 203-1188
Partner—Century City Office
lfeldman@pillsburywinthrop.com

Dana P. Newman (213) 488-7334
Partner—Los Angeles Office
dnewman@pillsburywinthrop.com

No End in Sight to Toxic Mold Uncertainty

by John S. Poulos



by Paul R. Schrecongost

The proliferation of toxic mold litigation has caused both lenders and property owners concern over how to address mold-related risk in mortgage loan documents. Environmental provisions of mortgage loan documents typically do not specifically address hazards such as toxic mold. Instead, deeds of trust, indemnification agreements and other mortgage loan documents generally impose upon owners remediation and indemnification obligations that are triggered by the presence of "hazardous materials." "Hazardous materials" are generally defined with reference to state and federal environmental laws. Because state and federal laws in the area of toxic mold are not well developed, the scope of an owner's obligations under such provisions is not entirely clear. Although California lawmakers have made efforts recently to provide for regulations that would clarify what types and levels of mold are hazardous, it is unlikely that such regulations will be forthcoming any time soon.

Scientific Uncertainty

A recent spate of multimillion-dollar awards in toxic mold cases has caused concern among owners and mortgage holders alike. Much of the concern stems from uncertainty over what types and

(Toxic Mold **continued on page 10**)

Age Restrictions on Senior Housing in California

by Michael Ouimette

Developers and operators of senior housing in the State of California should be aware of the age restrictions that apply to senior housing projects under state and federal law. California senior housing must comply with both state and federal law, and where the two laws differ, the more restrictive law applies. However, the age restrictions contained in California's Unruh Civil Rights Act (the "Unruh Act") are more onerous than those under federal law. This article discusses the effect of recent amendments to the Unruh Act on senior housing developments located in California.

The Unruh Act Imposes More Restrictive Age Restrictions than Federal Law

The Unruh Act prohibits California businesses from discriminating on the basis of age in the sale or rental of housing. The Unruh Act makes an exception, however, for housing that is restricted to senior citizens. While federal law allows up to 20% of the occupants of a senior citizen housing development to be less than 55 years old, Unruh requires that, with very limited exceptions, every dwelling unit of a senior citizen housing development contain at least one person at least 55 years of age. Because the more restrictive Unruh Act rule applies to senior developments in California, developers cannot comply with the law by, for example, renting 80% of the units in a development to seniors and the remainder to individuals who might otherwise qualify a development for a mixed-use exemption, such as disabled or low-income persons.

The Unruh Act continues to provide, with narrow exceptions, that each dwelling unit of a senior citizen housing development must be occupied by at least one person 55 years of age or older.

In 2000, the California Legislature attempted to amend the Unruh Act to ease these age restrictions, passing a bill that permitted up to 20% occupancy of a senior citizen housing

(Senior Housing **continued on page 10**)

The Hidden Costs of Preprinted Form Purchase Agreements

by Monique L.C. Wright

by Rachel B. Horsch

When entering into a purchase agreement for real property, buyers are often tempted to use preprinted forms provided by a broker and to simply attach an addendum that outlines the deal-specific terms. In doing so, buyers hope that an agreement drafted by a neutral third party will represent "standard" terms, saving attorneys' drafting fees and diminishing the chances that the seller will engage counsel and insist on lengthy negotiations. If the transaction proceeds smoothly, buyers probably won't run into problems using this approach.

A buyer needs to be wary, however, of taking such a simplistic approach to purchasing property. If problems arise, such a purchase agreement may raise more issues than it settles, lead to results that the parties would have never agreed to and even require litigation to resolve discrepancies and ambiguities. These problems frequently can be avoided by investing in a carefully drafted purchase agreement.

A buyer needs to be wary of taking the simplistic approach to purchasing property.

When Issues Arise

Quite often in the period between signing the agreement and closing on the property (which can be lengthy when bond allocations or other loan contingencies are involved) any number of issues arise: the seller might be looking for an out because the market has gone up, the buyer or the lender might discover some defect in the property that needs to be addressed, the buyer may need to walk away from the property (either pursuant to a termination right or by forfeiting deposits), the buyer may need continued access to the property after the diligence period to examine it further, or a contingency to closing might not occur.

If the parties and their attorneys consider the issues in advance and draft the document to address them, ambiguities and inconsistencies that could result in a dispute at a later date are minimized.

When issues like these arise, the parties will look to the document to determine the scope of their respective rights and obligations. It is at these times that a carefully drafted purchase agreement will pay off. If the parties and their attorneys consider the issues in advance and draft the document to address them, ambiguities and inconsistencies that could result in a dispute at a later date are minimized.

Common Problems

Each preprinted form has its own deficiencies, but we have found that the following provisions commonly cause problems, especially in affordable housing deals.

Approval Period/Inspections and Access

Inspection rights in preprinted forms are often not broad enough to meet a lender's requirements or are not appropriate for a given property. For instance, many times they do not specifically permit a buyer to perform Phase II Environmental Testing. In addition, the forms do not always make clear when a buyer's right to terminate may be exercised and may imply that the buyer needs to have a reasonable basis for terminating based on its due diligence. This can be dangerous; a buyer who intended to get a "free look" at a property may be forced to find a defect in the property in order to terminate the agreement. Also, the process of objecting to title issues, particularly those that arise after the expiration of the approval period, is not detailed enough. Finally, in affordable housing deals a buyer often has a need for additional access to the property even after the diligence period is over, since lenders will often need such access and are not involved until a much later date. Preprinted forms generally do not account for these and other concerns.

Representations and Warranties/Conditions Precedent

The representations and warranties and conditions precedent in preprinted forms tend to be generic and thus fail to address property- or deal-specific terms. In particular, representations for "ten-year holds," affordable occupancy levels and conditions regarding bond and other financing contingencies are not included. These shortcom-

(Preprinted Forms **continued on page 9**)

Pillsbury Winthrop LLP client, Chelsea Investment Corporation, developed the Torrey Highlands Apartments, a 76-unit, one-hundred percent affordable apartment complex located in Torrey Pines, California using tax-exempt bonds and low-income housing tax credits. The master developer, Greystone Homes, donated the land to Chelsea Investment Corporation for development of the affordable complex.

New Revisions of California Prevailing Wage Law Create Further Uncertainty

by Matthew Africa

On September 28, 2002, Governor Davis signed Senate Bill 972, which amended the California Labor Code sections that govern the application of prevailing wage requirements to projects constructed with public funds (the "Prevailing Wage Law"). Projects subject to the Prevailing Wage Law are required to pay wages approximately equal to union-scale levels. Less than a year before, the Legislature had enacted SB 975, which also modified the Prevailing Wage Law and, according to the preamble to that bill, specifically excluded "the construction or rehabilitation of affordable housing units for low- or moderate-income persons" from the scope of the Prevailing Wage Law. Although SB 972 does not indicate any explicit intention on the part of the Legislature to limit the exclusions for affordable housing units contained in existing law, many observers have interpreted the new bill as subjecting affordable housing to the Prevailing Wage Law. Developers of affordable housing projects estimate construction costs will be increased by 30%-40% under the Prevailing Wage Law, which many in the industry believe will have a dire impact on new construction of affordable housing units. We believe that the application of the Prevailing Wage Law to affordable housing developments is not supported by the language of the Prevailing Wage Law, SB 972's legislative history or case law.

Projects That Receive Assistance Only in the Form of Bonds Should Be Exempt from the Prevailing Wage Law

While existing law exempted projects that received allocations of bonds or tax credits prior to December 31 of this year, SB 972 adds a new exemption to the Prevailing Wage Law for projects that receive assistance from the state or a political subdivision only in the form of bond allocations. SB 972 added a new subsection to Section 1720 of the Labor Code that provides that a project is not subject to the Prevailing Wage Law if:

Although SB 972 does not indicate any explicit intention on the part of the Legislature to limit the exclusions for affordable housing units contained in existing law, many observers have interpreted the new bill as subjecting affordable housing to the Prevailing Wage Law.

> The public participation in the project that would otherwise [subject the project to the Prevailing Wage Law] is public funding in the form of below-market interest rate loans for a project in which occupancy of at least 40 percent of the units is restricted for at least 20 years by deed or regulatory agreement to individuals or families earning no more than 80 percent of the area median income.

The phrase "a project in which occupancy of at least 40 percent of the units is restricted for at least 20 years by deed or regulatory agreement to individuals or families earning no more than 80 percent of the area median income" is clearly intended to refer to affordable housing developments. Further, the phrase "public funding in the form of below-market interest rate loans" should be read to encompass bond allocations; where the state or a political subdivision issues bonds in connection with an affordable housing development, the project receives public funding in the form of loans at below-market interest rates due to the tax exempt interest rate on those loans. Thus, SB 972 appears to create an exemption for affordable housing developments that receive assistance only in the form of bond allocations, regardless of whether the development receives such an allocation before or after December 31, 2003.

SB 972 and SB 975 Do Not Clearly Subject Tax Credit Financed Affordable Housing to the Prevailing Wage Law

Furthermore, the portions of SB 972 and SB 975 that purportedly make affordable housing developments that receive tax credits from the state or a political subdivision subject to the Prevailing Wage Law are ambiguous. The Prevailing Wage Law requirements apply to projects that are "paid for in whole or in part out of public funds," but it is unclear whether tax credits constitute "public funds." "Public Funds" is defined in California Labor Code Section 1720(b) to include: direct payments or performance of

(Prevailing Wage **continued on page 7**)

(NMTCs continued from cover)

Despite the delays in implementing the NMTC program, recent Treasury and Internal Revenue Service rulings provide a number of positive developments for investors and syndicators of NMTCs.

CDFI Fund Backlog

The Treasury Department announced that in the first round of competition for an allocation of NMTCs it has received 345 applications requesting authority to provide investors tax credits on an aggregate total of over $25.8 billion in potential equity investments. This far exceeds the amount for which tax credits can be claimed in the first round, up to $2.5 billion in equity investments. The total of equity investments allowed under the program is $15 billion, which will be made available in a phased-in basis through 2007. Many investors are hopeful the industry-wide enthusiasm for the new, albeit untested, federal program will drive President Bush to provide increased NMTC support in his economic stimulus package.

On the other hand, the delay in the allocation of NMTCs by the CDFI Fund, originally scheduled for the end of 2002, has resulted in investor fatigue due to uncertainty about the new program and hesitance by developers to incur costs for investment projects marked for the first round of allocation. As of the date of this publication, CDFI Fund insiders estimate the first round of allocation of NMTCs will be announced late in February 2003.

Recent Revenue Ruling a Positive Development for NMTC Investors

A recent revenue ruling offers good news for NMTC investors and syndicators. In Revenue Ruling 2003-20, the Treasury Department and IRS determined that a partnership or limited liability company ("LLC") classified as a partnership may finance the purchase of a qualified equity investment eligible for the NMTC with proceeds of non-recourse debt of the partnership. The ruling says that, for purposes of determining the NMTC allowable under Section 45D of the Internal Revenue Code, the amount of the qualified equity investment made by an LLC classified as a partnership includes cash from a non-recourse loan to the LLC that the LLC invests as equity in a qualified community development entity ("CDE"). This ruling is a positive development for NMTC investors and syndicators, as the ruling provides flexibility in aggregating funds by an investor fund LLC when making a qualified equity investment in a CDE. As a result, investors do not need "equity" to generate a qualified equity investment in a CDE in order to claim NMTCs. The recent development will also allow investors, syndicators and CDEs more flexibility in determining and negotiating the rate of return on the equity investments.

Despite the delays in implementing the NMTC program, recent Treasury and Internal Revenue Service rulings provide a number of positive developments for investors and syndicators of NMTCs.

The following example illustrates the application of Revenue Ruling 2003-20 to a CDE which funds a qualified equity investment from both non-recourse debt and equity funds:

Investor Fund LLC receives $50M in equity from investors X and Y for membership interests in Investor Fund LLC, and $50M in a non-recourse loan from Bank. Investor Fund LLC uses the $100M proceeds to make a $100M contribution in CDE, a qualified community development entity under Section 45D. CDE designates Investor Fund LLC's equity investment in CDE as a qualified equity investment under Section 45D of the Internal Revenue Code. Under Revenue Ruling 2003-20, the CDE can allocate NMTCs based upon the $100M contribution from the equity investors and the Bank (approximately, $39M in NMTCs) instead of the $50M funded solely from investor equity (approximately, $19.5M in NMTCs).

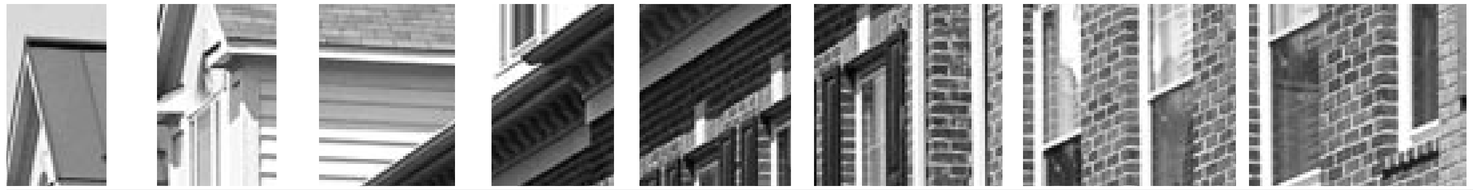
Longer Investor "Look-Back" Period

A recent notice issued by the Treasury Department and the IRS also benefits investors and syndicators. Because the CDFI Fund was unable to complete NMTC allocation by January 1, 2003, the agencies issued a notice that amends the NMTC governing regulations, specifically Section 1.45D-1T(c)(3)(ii), extending the deadline for CDEs relating to certain equity investments made before the receipt of an NMTC allocation. The issuance, Notice 2003-9, revises and extends the 'look back' period for equity investments made before the receipt of an NMTC allocation under Section 45D(f)(2). The notice sets three criteria to allow a CDE to claim investments made in the CDE before it had entered into an allocation agreement with the Treasury Department regarding a qualified equity investment. To be eligible for the look-back, (a) the equity investment must have been made on or after April 20, 2001; (b) the designation of the equity investment as a qualified equity investment must have been made for a credit allocation received pursuant to an allocation application submitted to the CDFI Fund no later than August 29, 2002; and (c) the equity investment otherwise must satisfy the requirements of the NMTC statute and regulations. Thus, Notice 2003-9 provides some relief for the early investors and syndicators of NMTCs in the new federal program.

Jason Hobson is a Senior Associate in the San Francisco office and may be reached via email at jhobson@pillsburywinthrop.com or by phone at (415) 983-1929.

The NMTC program was established to generate $15 billion in new private sector investments in low-income communities. Under the program, qualified Community Development Entities ("CDEs") can apply to the CDFI Fund for an award of NMTCs. The CDE will then seek taxpayers to make Qualifying Equity Investments in the CDE. The CDE will in turn be required to use substantially all of the Qualifying Equity Investments to make Qualified Low-Income Community Investments in/to Qualified Active Low-Income Businesses located in low-income communities. The taxpayer will be eligible to claim a tax credit equal to 5 percent of its equity investment in the CDE for each of the first three years and a 6 percent credit for each of the next four years, or a total of 39 percent.

The program is designed to allow the CDE to use its local knowledge and expertise to decide what business to invest in or lend to with the funds it raises with the NMTCs. Most businesses located in low-income communities could qualify for loans or equity. Typical businesses could include: small technology firms, inner-city shopping centers, manufacturers, retail stores or micro-entrepreneurs.



As Federal and State Subsidies to Older Projects Expire, Developers and Public Entities Focus on Affordable Housing Preservation

By Gary P. Downs
and
Jason A. Hobson

In California, there are approximately 149,000 units of privately owned, federally assisted multifamily rental housing, plus additional tax credit and mortgage revenue bond properties, many with project-based rental assistance. A large percentage of these units may convert to market rate as project-based subsidy contracts or regulatory agreements expire. These at-risk units are occupied by lower-income tenants who cannot afford to pay market rate rents and who could be displaced if the projects convert.

Many cities, counties and public housing authorities are concerned about the conversion of affordable units to market rate units and are taking steps to preserve the units as affordable housing. These public entities are responding to the problem with a range of incentives that provide developers with valuable new opportunities. This article highlights a recent success story of the acquisition of an affordable housing project originally subsidized under the Department of Housing and Urban Development ("HUD") Section 236 program, as well as certain of the issues unique to acquiring a project with an expiring state or federal subsidy.

Profile of a Recent Preservation Success Story

In April 2002, Pillsbury Winthrop client Pacific American Properties, Inc. ("Pacific") closed on the acquisition and financing of the Bryte Gardens Apartments, an existing affordable housing development located in West Sacramento, Yolo County, California. The project had been subsidized under the HUD Section 236 affordable housing program. The state bond agency required Pacific to keep the project "affordable" and Pacific had a number of options for doing so. The typical strategy for preserving Section 236 projects is to "decouple" the Section 236 interest-reduction payment from the old Section 236 mortgage and apply that subsidy to new financing with new income restrictions, but that alternative was not economically feasible for the Bryte Gardens Apartments. Instead, Pacific decided to prepay the Section 236 mortgage and to recapitalize the project with tax-exempt bonds, 4% low income housing tax credits ("LIHTCs") and additional subsidies provided by HUD through the local public housing agency, the Sacramento Housing and Redevelopment Agency ("SHRA").

Because many Bryte Gardens residents could not afford the relatively high rents of a tax-exempt bond and tax credit project, Section 8 vouchers were needed to fill the gap. HUD offers enhanced Section 8 vouchers to tenants at older affordable properties like Bryte Gardens that are threatened with conversion to market-rate housing, referred to as a "housing conversion action." These enhanced vouchers pay the rents that the apartments would earn if they became market-rate units. The payment standard for enhanced vouchers is the gross rent of the unit, provided HUD determines that the gross rent is reasonable in comparison to similar, unassisted units in the market area. These higher rents support more conventional-level debt.

Pacific and Pillsbury Winthrop worked with HUD to arrange the prepayment of the Section 236 mortgage and the transfer of the physical asset, which allowed tenants residing at the project to receive enhanced Section 8 vouchers. Enhanced vouchers have a special minimum rent requirement, whereby the household recipient must continue to contribute at least the same amount the recipient was paying for rent on the date of the housing conversion action. These enhanced vouchers are tied to the project in which the housing conversion action took place. If a tenant moves from the project, the enhanced feature is eliminated and the voucher will have the features of a regular voucher under the HUD program, which payment features are often determined by the local public housing agency as 30% of adjusted monthly income. Pacific was concerned about the "enhanced" nature of vouchers, since HUD's enhanced vouchers will eventually leave the project through resident attrition and the voucher program requires an annual reauthorization from Congress. To provide a level of subsidy continuity, Pacific entered into a Housing Payment Contract that provided a project-based subsidy, as opposed to a tenant-based voucher, for 11 Section 8 units at Bryte Gardens Apartments.

Unique Issues Presented by Housing Preservation

Preservation deals present a number of unique issues. Developers must have a basic understanding of these issues in order to work with the appropriate governmental agencies to successfully finance and operate preservation projects.

State Notice Requirements

Federal and state law require that an owner provide tenants with notice of the owner's desire to opt out of Section 8 or prepay a federally assisted mortgage that contains rental restrictions. Federal law requires that notice be provided from 5-9 months for prepayments and 12 months for opt-outs. California law requires that owners provide a 12-month and 6-month notice to tenants, local public agencies, and the Department of Housing and Community Development. The notices are required to contain specific information regarding the anticipated housing conversion action. Failure to meet the required notice dates or include the required information could result in the 12-month notice period being restarted, which is often a deal-killer. California law also requires owners to give qualified preservation purchasers (known as "qualified entities") an opportunity to purchase the property if the owner decides to opt out or prepay or if the property is going to be sold prior to that decision. An exemption from these notice requirements was enacted in 2001 for projects that will preserve affordability and that have included these affordability protections in their regulatory agreements.

(Preservation **continued on back cover**)

CDLAC Adjusts 2003 Allocation Process for Qualified Residential Rental Projects

by Tuan A. Pham

On January 15, 2003, the California Debt Limit Allocation Committee ("CDLAC") approved a number of adjustments to the allocation process for qualified residential projects in program year 2003. As in 2002, CDLAC will hold three bond volume cap allocation rounds in 2003. However, CDLAC's new procedures: 1) set the allocation amount for the General Pool and the Mixed-Income Pool for the third round higher than for the first two rounds; 2) indicate CDLAC's intention not to shift allocation out of the General Pool to fund mixed-income projects, as it had in 2002; and 3) apply a point threshold, withholding allocation from a project scoring below 70 points until after the third round. In addition, CDLAC reserved its right to revise the point threshold upward or downward based on activity and competition in the allocation rounds.

These adjustments are designed to ensure that there will be sufficient allocation to fund all viable General Pool projects in program year 2003 and to respond to anticipated over-subscription in the third round. Perhaps unintentionally, these procedural changes raise the competitive bar for mixed-income projects (projects with 50% or less of total units restricted to low- or very low-income tenants).

CDLAC's Allocation Is a Response to Anticipated High Demand in the Third Round

In 2003, the General Pool consists of approximately $968 million and the Mixed Income Pool is $418 million. This is an increase from 2002 of over $43 million in the General Pool, and $40 million in the Mixed-Income Pool. Unlike in 2002, where approximately one-third of each Pool was allocated to each allocation round,

(CDLAC Procedures **continued on page 9**)

(Prevailing Wage **continued from page 4**)

construction work by a state or political subdivision; transfers of assets for less than fair market price; the waiver or reduction of charges in connection with the execution of a contract; loans to be repaid on a contingent basis; and credits against repayment obligations to a state or political subdivision. Of these categories, only one, "credits that are applied by the state or political subdivision against repayment obligations," appears to refer to allocations of bonds or tax credits, and even that is questionable because taxes are not "repayment obligations." A close reading of the statute suggests that an affordable housing development should not be subject to the Prevailing Wage Law merely because it receives tax credits from the state or a political subdivision. Furthermore, even if this section is intended to refer to tax credits, it does not pick up assistance in the form of federal tax credits.

Nonetheless, Section 1720(d) of the Prevailing Wage Law, as amended by SB 972 and SB 975, states several exclusions that have affected the interpretation of how the Prevailing Wage Law is applied to affordable housing. Subsections 1720(d)(1) and 1720(d)(3) state that projects shall not be subject to the Prevailing Wage Law solely because they receive allocations of bonds or federal or state low-income housing tax credits prior to December 31, 2003. These exclusions imply that, but for such an exclusion, projects that receive allocations of bonds or tax credits would otherwise be subject to the Prevailing Wage Law, notwithstanding the fact that such financing is not a payment "in whole or in part out of public funds." Furthermore, these exclusions imply that after January 1, 2004, affordable housing units constructed with funding that includes allocations of bonds or state or federal tax credits will be subject to the Prevailing Wage Law. These exclusions have persuaded many observers that a project that receives an allocation of bonds or tax credits after January 1, 2004 is obligated to pay prevailing wages.

The Legislative History of SB 972 Does Not Indicate an Intention To Subject Affordable Housing to the Prevailing Wage Law

However, the legislative history of SB 972 is ambiguous as to whether or not affordable housing units constructed with funding that includes allocations of tax credits or bonds are subject to the Prevailing Wage Law. The analyses from the Assembly and Senate floors state that "Existing Law" (i.e., prior to the enactment of SB 972) "[e]xcludes from the definition of 'public works,' for the purpose of determining the applicability of prevailing wage requirements, the construction or rehabilitation of affordable housing units for low- or moderate-income persons, as specified." See Senate Floor Analysis of August 26, 2002. Accordingly, it appears that the Legislature believed that the construction and rehabilitation of affordable housing, however funded, was already exempt from the Prevailing Wage Law under existing law.

Much of the confusion regarding the application of the Prevailing Wage Law stems from the insertion and deletion from SB 972 of a provision that would have explicitly exempted affordable housing developments that receive both allocations of bonds and of tax credits from the scope of the Prevailing Wage Law. That provision stated that assistance which "is public funding in the form of below-market interest rate loans, *with or without tax credits*" would not subject an affordable housing development to the Prevailing Wage Law. The enacted version of SB 972 deleted the phrase "with or without tax credits." Although the implication may be that the phrase "with or without tax credits" was deleted because the Legislature did not want to explicitly exempt projects partially funded by tax credits, there is nothing in the legislative analyses to explain the redrafting of this provision. The fact that the legislative analyses indicate that the Legislature believed affordable housing to be exempt from prevailing wage laws suggests that the Legislature might have thought it unnecessary to exclude affordable housing from the scope of the Prevailing Wage Law by including the "with or without tax credits" language.

Case Law Indicates That Tax Credits Do Not Constitute Public Funds

Furthermore, case law suggests that tax credits do not constitute "public funds." Although no California case has explicitly so held, the weight of authority in other jurisdictions clearly indicates that an allocation of tax credits does not constitute a grant of public funds. *See, e.g., Toney v. Bower*, 744 N.E.2d 351, 357-58 (Ill. App. Ct. 2001) (holding that a tax credit is not a public fund or an appropriation of public money); *accord Griffith v. Bower*, 747 N.E.2d 423, 426 (Ill. App. Ct. 2001); *Kotterman v. Killian*, 972 P.2d 606, 618-20 (Ariz. 1999). In fact, we could find only one reported case that holds that tax credits are public funds. *See Curchin v. Missouri Industrial Development Board*, 722 S.W.2d 930, 933 (Mo. 1987) ("There is no difference between the state granting a tax credit and forgoing the collection of the tax and the state making an outright payment to the bondholder

(Prevailing Wage **continued on page 9**)

(Federal and State Squeeze continued from cover)

in unused low-income housing funds. However, more recent figures, such as the 2001 State Controller's report, indicate that the actual amount of unused funds is far lower, on the order of $100 million, and that roughly $400 million has been committed to projects for which final contracts had not been signed. Further, affordable housing supporters argue that the Governor's proposal is based on a fundamental misunderstanding of industry practices, such as waiting until the completion of planning to sign contracts, and that to withdraw funding for such projects would engender lawsuits.

The withdrawal of tax increment money may threaten the viability of projects needing gap financing, meaning that fewer affordable units will be preserved, built or rehabilitated.

Furthermore, affordable housing supporters also argue that the proposal may be contrary to the State Constitution, which requires property tax revenues to be used in the county in which they were generated. This resistance has caused the Davis administration to back away from its initial proposal and to suggest that instead of shifting affordable housing tax increment funds to the state general fund, the state could transfer the funds to schools within the county in which moneys were generated and then make a corresponding cut in the state's funding to county schools. Affordable housing supporters have objected to this new proposal as a sleight of hand that would allow the state effectively to launder redevelopment funds.

The Tax-Free Dividend

On January 7 of this year, President Bush announced a proposal to eliminate the taxation of corporate dividends as part of his economic stimulus package. At first glance, this idea has some appeal because it would eliminate double taxation of corporate profits and it might stimulate additional investment in America's sluggish stock markets.

However, these possible benefits would come at a significant cost to states, municipalities and the affordable housing industry, all of which have benefited from being able to offer investors a premium on investments in the form of a tax-free return on tax-exempt bonds. These tax-exempt bonds have been traditionally one of the few tax-exempt investment vehicles, but President Bush's proposal threatens to add a large category of new tax-exempt investments that will likely decrease investor demand for tax-exempt bonds. To make bonds an attractive investment, issuers would have to increase bond interest rates, which would increase the cost of borrowing for states, municipalities and affordable housing developments. For example, a report recently issued by California State Treasurer Phil Angelides estimates that California alone could be forced to pay up to $17.2 billion over the next 10 years in additional interest costs if Congress approves of the dividend tax cut as proposed.

The United States Tax Code is the most significant and complicated legislation ever codified to control social and economic behavior. Corporate policy and whole industries were created in response to the incentives created by the double taxation of corporate profits. Changing these incentives radically is likely to have significant unintended consequences. In regard to affordable housing, corporate investment currently accounts for more than 98% of the equity capital generated by the Low Income Housing Tax Credit. In recent years, that tax credit has driven the production of affordable units more than any other subsidy. The National Council of State Housing Agencies believes that if Congress enacts the proposal, corporations will forgo investment in housing tax credits in favor of maximizing the distribution of tax-free dividends to shareholders. Under the proposal, only dividends that a corporation distributes from after-tax earnings are tax-exempt. Tax credits taken by a corporation eliminate taxes on certain earnings. The corporation will not be able to distribute these earnings tax-free. We understand that traditional tax credit investors are already withholding investment in the face of President Bush's proposal.

We are optimistic that the politicians will put housing first and will find ways to balance budgets and stimulate the economy that do not threaten the viability of affordable housing. Nonetheless, we urge you to contact your political representatives with your concerns.

If enacted, President Bush's dividend proposal threatens to sunset the housing tax credit and other tax credit programs. When coupled with higher borrowing costs, the chill on investment would cripple the now robust and much-needed development of affordable housing.

We are optimistic that the politicians will put housing first and will find ways to balance budgets and stimulate the economy that do not threaten the viability of affordable housing. Nonetheless, we urge you to contact your political representatives with these concerns.

Gary Downs is a Partner in the San Francisco office and may be reached via email at gdowns@pillsburywinthrop.com or by phone at (415) 983-1835.

MacFarlane Partners and Madison Marquette are co-developing a large mixed-use project in Emeryville. Pillsbury Winthrop LLP was lead counsel to the developer in regards to the Bond financing of the multi-family component of the project.

(Prevailing Wage continued from page 7)

from revenues already collected."). Finally, the only California case that we could locate that discusses tax credits and public funds suggests that an allocation of tax credits is not a grant of public funds. *See Center for Public Interest Law v. Fair Political Practices Commission*, 210 Cal. App. 3d 1476, 1486 (Cal. Ct. App. 1989) ("the credit received by the taxpayer the following year involves no expenditure of public moneys received or held . . . but merely reduces the taxpayer's liability for total tax due. Although the result of both systems is to reduce available tax revenue, the current system involves no expenditures of public money . . . ."). This suggests that if a California court were to consider the question, it would hold that a project that is allocated federal or state low-income housing tax credits is not solely by reason of such tax credits "paid for in whole or in part out of public funds," and thus that such a project would not be subject to the Prevailing Wage Law.

SB 972 Remains Untested

Although it is less than clear that SB 972 subjects affordable housing projects that receive bond or tax credit allocations to the Prevailing Wage Law, anecdotal evidence suggests that affordable housing developers have interpreted the legislation to mean that prevailing wage requirements will apply to projects that receive allocations of the bond ceiling or of tax credits after January 1, 2004. This has driven many to vie for volume cap allocation prior to December 31, 2003 (see "New CDLAC Procedures," p. 6). Although it is our belief that the application of the Prevailing Wage Law to affordable housing is not supported by the language of the Prevailing Wage Law, SB 972's legislative history or case law, we are currently helping clients to mitigate the impact of the Prevailing Wage Law on their projects by working with the Department of Industrial Relations on our clients' behalf and by counseling them about compliance with the law. In the meantime, we are optimistic that the ambiguity of SB 972 will lead the Legislature to reconsider the application of prevailing wage requirements to affordable housing. As Governor Davis indicated in his signing message, SB 972 is "a step in the right direction" but "there may be a need for clean-up legislation next year." We hope that the Legislature gets it right the third time.

Matthew Africa is an Associate in the San Francisco office and may be reached via email at mafrica@pillsburywinthrop.com or by phone at (415) 983-1850.

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ings may force a buyer to spend additional money on diligence. If such representations and conditions are added by addenda, they are often not adequately integrated into the document and the buyer may later find that he does not in fact have the breadth of protection that he anticipated.

Deposits/Liquidated Damages

Preprinted forms may not deal adequately with the circumstances under which a deposit is refunded and/or applied to the purchase price. Furthermore, many preprinted forms do not include an adequate liquidated damages clause to limit liability to a certain amount (usually the amount of the deposit) should the buyer decide or have the need to walk away from the deal. A carefully drafted agreement can provide these protections as well as industry-specific terms, such as allowing that the deposit be in the form of a note until the bond financing contingency has been removed.

Boilerplate Language

Many preprinted forms do not include simple boilerplate language that is important to have should a dispute arise. For instance, many forms omit integration clauses. Integration clauses prevent the parties from including prior communications as part of the agreement governing the property. If a dispute arises and the purchase agreement does not contain an integration clause, the seller may be able to bring in evidence of negotiations, such as a letter of intent or even oral communications, which the parties had intended to replace with the purchase agreement. This can be dangerous especially since such evidence tends to address topics only in a general matter.

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(CDLAC Procedures continued from page 6)

CDLAC has adopted a 30%/30%/40% split for 2003. CDLAC has cited numerous reasons for this change, all of which suggest that the third round will be extremely competitive this year. First, CDLAC anticipates that the program winners from the Department of Housing and Community Development's Multi-Family Housing Program and HOME funds will participate in CDLAC's second and third rounds, demanding approximately $320 million in total allocation. Second, CDLAC anticipates that projects that are unsuccessful in obtaining 9% tax credits from the California Tax Credit Allocation Committee's ("CTCAC") first 9% round will apply as bond projects competing in CDLAC's third round. Last year, 11 projects that were unsuccessful at CTCAC applied for bond financing and requested approximately $73 million in bond allocation in the final round. This demand could accelerate if CTCAC creates incentives to projects that skip the 9% tax credit process and compete for bond allocation, as it is currently considering. Third, due to legislation requiring the payment of prevailing wages in the construction of affordable housing developments that receive allocation after January 2004 (see "Prevailing Wage Law," p. 4), issuers and developers have expressed their intention to submit as many applications as possible prior to January 2004. Lastly, CDLAC pointed to its previous experience in 2002 (the only other year to have three allocation rounds for rental projects), in which the demand for allocation in the third round was approximately two times the demand in the first or second rounds.

New Procedural Changes Make It Harder for Mixed-Income Projects To Compete

CDLAC's other procedural adjustments are designed to ensure that there will be sufficient allocation to fund all viable General Pool projects in program year 2003. CDLAC's stated intention not to transfer allocation from the General Pool and to restrict allocation to projects scoring less than 70 points until after the third round will likely achieve such effect, but will make it harder for mixed-income projects to compete for allocation. That is, only General Pool applicants (applicants with projects that restrict more than 50% of units to low- or very low-income tenants), as opposed to applicants with mixed-income projects, will be eligible for bond allocation from the General Pool. Moreover, only high-scoring projects—those that are awarded points under CDLAC's evaluation procedure for criteria ranging from increased affordability to site amenities—will receive an initial allocation.

As a result of these changes, the competition for allocation among mixed-income projects is expected to increase dramatically. For instance, according to information provided by CDLAC, last year 12 mixed-income projects that did not obtain a sufficient score to receive allocation from amounts reserved for mixed-income projects ultimately received allocation from unused allocation taken from the General Pool or other CDLAC reserved pools, over $275 million in total. Assuming that CDLAC does not transfer any allocation from the General Pool or other pools, and that demand remains the same in 2003, a $235 million allocation shortage for mixed-income projects will appear in 2003, even accounting for this year's $40 million increase in bond volume capacity in the Mixed-Income Pool. Moreover, if

(CDLAC Procedures continued on back cover)

(Senior Housing continued from page 2)

development by persons who are not seniors, as is allowed under federal law. Unfortunately, Governor Davis vetoed a portion of this legislation because it included a $250 tax on developers and, due to additional legislative hijinks, the proposed amendment allowing 20% occupancy by non-seniors never became operative. Therefore, the Unruh Act continues to provide, with narrow exceptions, that each dwelling unit of a senior citizen housing development must be occupied by at least one person 55 years of age or older.

Permissible Age Restrictions

Two types of age restrictions are permissible for senior housing projects. Under the first type, occupancy of the project may be limited to persons over the age of 62. Unfortunately, this means that literally every single occupant of the housing project, including spouses, must be over the age of 62, so if an occupant is 65 but the occupant's spouse is 59, they could not live together in this development without jeopardizing the legality of the project. As a practical matter, this age restriction scheme is not feasible for most senior housing projects.

Among the risks of nonqualification as a Qualified Senior Development is exposure to civil suits under the Unruh Act by persons excluded from the project on the basis of age.

Alternatively, developers may restrict the occupancy of a project to persons over the age of 55 if a project qualifies as a "senior citizen housing development" under the Unruh Act (a "Qualified Senior Development"). The Unruh Act used to contain an existing housing and population density formula that made it difficult to qualify as a Qualified Senior Development, especially if the project was located in a rural area. However, in 2001, the Unruh Act was amended to provide that any project developed, rehabilitated or renovated for senior citizens that has at least 35 dwelling units can qualify as a Qualified Senior Development. To qualify, the project must also be designed to meet the physical and social needs of seniors, and at the commencement of occupancy of any dwelling unit there must be at least one person who is 55 years old or older who intends to reside in the unit as his or her primary residence on a permanent basis (a "Qualifying Senior"). There is some flexibility under the Unruh Act with regard to what other persons may reside in the dwelling unit with the Qualifying Senior, and certain persons may not be excluded from the dwelling unit, even if the Qualifying Senior vacates the dwelling unit.

Drafting Covenants, Conditions & Restrictions

The Unruh Act requires that limitations on occupancy, residency or use on the basis of age must be set forth in the Qualified Senior Development's covenants, conditions and restrictions and other documents or written policies. The Unruh Act sets a floor and a ceiling with regard to the age restrictions a Qualified Senior Development may adopt. The least exclusive restriction allowable is a provision requiring that the persons commencing any occupancy of a dwelling unit include a Qualifying Senior. Developers who wish to provide for a more exclusive policy should note that the Unruh Act requires that "qualified permanent residents," "permitted health care residents" and certain persons who are grandfathered in, so to speak, must be allowed to occupy a dwelling unit with a Qualifying Senior. In some circumstances, these other residents must be permitted to remain even if the Qualifying Senior later vacates the unit. These provisions of the Unruh Act are complex, and developers are advised to seek the advice of counsel when drafting these written restrictions.

Conclusion

Developers and operators of senior housing projects must take care to avoid violating the provisions of the Unruh Act. This will involve setting appropriate age restrictions and ensuring that the project is designed to meet the physical and social needs of seniors. Among the risks of nonqualification as a Qualified Senior Development is exposure to civil suits under the Unruh Act by persons excluded from the project on the basis of age. Counsel can assist in this regard by advising developers on the design requirements required of a Qualified Senior Development, drafting appropriate age restrictions and helping operators of senior housing projects address occupancy problems which arise during the operation of the project.

Michael Ouimette is an Associate in the San Francisco office and may be reached via email at mouimette@pillsburywinthrop.com or by phone at (415) 983-1163.

(Toxic Mold continued from page 2)

quantities of mold are harmful to humans. Molds are simple, microscopic organisms that are present virtually everywhere, both indoors and outdoors. To date, only a handful of scientific studies have examined the potential health effects of exposure to mold, and experts disagree about whether such studies have even established a causal relationship between exposure to mold and human illness.

The California State Department of Health Services ("DHS") has stated that, at present, there exists no test for determining whether a specific illness is linked to mold exposure. At the same time, the DHS advises that exposure to indoor mold at sufficient levels can cause allergies and other health problems (see the DHS publication, "Mold in My Home: What Do I Do?," available at http://www.dhs.ca.gov/ps/deodc/ehib/ehib2/PDF/MOLD_2001_07_17FINAL.pdf). Since mold of some sort can be found in virtually every structure, the multimillion-dollar question for owners and lenders is: *when is mold dangerous?*

Legislative Developments

California has taken the lead in trying to implement legal standards for toxic mold. California's Toxic Mold Protection Act of 2001 (the "Mold Act"), which became effective on January 1 of this year, was meant to establish permissible mold exposure limits. The Mold Act directs the DHS to determine the feasibility of devising permissible exposure limits and standards for assessment, identification, remediation and abatement of indoor mold. However, the Mold Act itself provides that it will be implemented only to the extent that the DHS determines that funds are available for its implementation.

The DHS estimates that implementing the Mold Act would cost $400,000 this budget year and $700,000 in each of the next two or three budget years. The state budget proposed by Governor Gray Davis in January does not show any funding for implementation of the Mold Act. DHS has indicated that there is likely to be no funding for the Mold Act in the budget and, without such funding, the agency will be unable to implement the Mold Act. Even State Senator Deborah Ortiz, who sponsored the Mold Act, has acknowledged that the state's financial difficulties may delay implementation of the law for a year or more.

Litigation and Remediation Risks

Scientific and regulatory uncertainty notwithstanding, plaintiffs' lawyers are not waiting for implementation of the Mold Act to file toxic mold tort suits. Property owners, contractors, subcontractors, construction managers, property managers, architects, construction component suppliers and insurance companies have all been defendants in mold cases. In November 2001, a Sacramento family won a $2.7 million jury verdict against its landlord on a toxic mold claim. And in June 2002, a Texas jury awarded a family $32 million in compensatory and punitive damages against an insurance company for bad faith in its handling of a leaky pipe claim that allegedly caused the spread of toxic mold.

Since mold of some sort can be found in virtually every structure, the multimillion-dollar question for owners and lenders is: *when is mold dangerous?*

The cost of defending a toxic mold claim can be considerable. Toxic mold litigation alleging bodily injury involves the use of medical and other scientific experts by plaintiffs and defendants. If anything, the lack of recognized standards for determining what types and quantities of mold are hazardous gives both sides more to argue about, which increases the costs of even successful litigation. Such uncertainty, coupled with popular misconceptions about indoor mold, may also increase the chance that a frivolous case will result in an unjustified award.

In addition to the risk of costly litigation, abatement of mold can also be expensive. Remedial procedures for abating mold range from simple cleanup to demolition and replacement of affected structural elements. If required during the construction phase of an apartment building, extensive remediation can delay the completion of construction and jeopardize the project. If required after the construction phase, such remediation could involve a costly temporary relocation of tenants and interrupt a stream of rental revenue needed to service the loan.

Addressing Mold Risks in Agreements

Given the potential costs of mold-related litigation and remediation, mortgage loan documents should allocate the risks associated with harmful mold. Most "hazardous materials" clauses currently do not clearly allocate risks because mortgage loan documents typically define the term "hazardous material" as any substance the presence of which is prohibited in residential dwellings by state or federal laws and currently there are no state or federal laws prohibiting the mere presence of mold. Furthermore, mold may be found in virtually any structure and comes in thousands of varieties, only a handful of which are thought to be harmful to humans. While the Mold Act may ultimately provide guidelines for determining when mold is a "hazardous material," until the DHS has the funds to develop such guidelines, property owners and mortgage holders will not be able to rely on generic hazardous materials clauses to determine when an owner's remediation and indemnification obligations are triggered. In the absence of clear governmental standards, lenders and developers should understand the circumstances under which mold creates risks and be prepared to negotiate how such risks should be addressed in the documents.

Pillsbury Winthrop has represented clients in connection with the remediation and litigation of toxic and nontoxic mold problems. We are available to assist with everything from referrals to scientists and specialty contractors in connection with remediation efforts, to handling the litigation of mold-related claims.

Conclusion

Due to state budget constraints, it is unlikely that the Mold Act will fulfill its promise of providing for toxic mold guidelines any time soon. As a result, parties to mortgage loan documents will have to negotiate provisions that specifically address an owner's indemnification and remediation obligations as they relate to mold. Such provisions should be drafted carefully to allocate potential mold-related risks and to ensure that the mere appearance of mold does not trigger a default.

John S. Poulos is a Partner in the Sacramento office and may be reached via email at jpoulos@pillsburywinthrop.com or by phone at (916) 329-4756.

Paul R. Schrecongost is an Associate in the San Francisco office and may be reached via email at schrec@pillsburywinthrop.com or by phone at (415) 983-1863.

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Brokers

Not surprisingly, the one area where the broker's form will tend to be quite detailed is in establishing the rights and obligations of the parties with respect to the brokers, often going so far as to obligate the parties to pay commissions, fees and costs incurred by the brokers in excess of the obligations that such party has under a separate agreement with their broker.

A buyer is taking risks with preprinted forms, especially in an affordable housing deal, when the period between signing the agreement and closing the sale can be so long.

Conclusion

Preprinted forms may save money during the negotiation and may very well provide a sufficient agreement to take the parties through a successful closing. However, a buyer is taking risks with preprinted forms, especially in an affordable housing deal, when the period between signing the agreement and closing the sale can be so long. These risks include losing financing because the agreement does not adequately cover lenders' requirements, losing the property to another buyer because of a loophole that benefits the seller, losing the pre-paid deposit because the conditions of refundability are not adequately spelled out, and ending up in costly litigation. Investing in a carefully drafted purchase agreement will help to minimize these risks.

Monique L. C. Wright is a Senior Associate in the San Francisco office and may be reached via email at mwright@pillsburywinthrop.com or by phone at (415) 983-1579.

Rachel Horsch is an Associate in the San Francisco office and may be reached via email at rhorsch@pillsburywinthrop.com or by phone at (415) 983-1193.