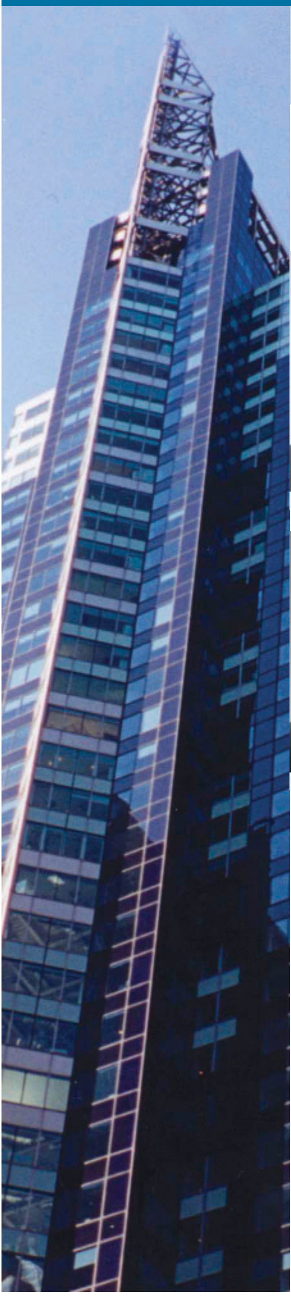
PILLSBURY WINTHROP LLP

on real estate

SPRING 2004

a newsletter for the real estate industry



THE CHALLENGE OF Housing Affordability

Every cloud has its silver lining -- and every silver lining has its cloud. The wisdom of the first statement is evident in the positive impact that the collapse of the securities markets in 2000 had on interest rates and residential real estate prices over the past few years as investors shifted out of stocks and into real property assets, like homes, which saw a tremendous increase in value. The cloud in the silver lining of higher real estate prices, however, is that affordable housing, both rental and single family, is fast becoming an oxymoron. As home prices continue to rise, more and more Americans find themselves priced out of home-ownership and struggle to find affordable rental housing. Affordable housing is crucial in attracting and retaining business, sustaining employment growth and ensuring a healthy political and economic climate in our communities. Recognizing the impact that affordable housing has on our communities, Congress and local government have stepped in with initiatives that promote and facilitate the construction of affordable housing.

SELLER'S MARKET STRAINS RENTAL HOUSING

One place where a seller's market exists is in Southern California's residential real estate sector, where supply is dwarfed by demand. Since 1984, over 287,000 net jobs were created in Los Angeles and Orange Counties, yet only 78,000 single family residences were built. According to DataQuick, the median price of an existing home in California in November 2003 increased 17.8% year-over-year and sales increased 15.7% over the same period. The median home price in Los Angeles is now in excess of $365,000, which, at today's interest rates, requires a monthly debt service payment of around $1,750, assuming 20% down and a 6% interest rate. Meanwhile, median monthly income in Los Angeles County for a family of four is $3,640.

Since an affordable home is commonly thought of as one that requires the payment of no more than 30% of a family's annual income toward principal, interest, property taxes and insurance, a quick calculation between income and housing costs shows a dramatically widening gap between what we earn and what we can afford to pay for a home. Staggeringly, one in eight lower-income working families earning at least the full-time equivalent of the minimum wage reported spending more than half of their incomes on housing.

However, statistics alone do not adequately convey the impact of a lack of adequate affordable housing on a community. A decent, affordable place to live brings with it certain quality of life benefits fundamental to a strong and stable nation. Improvements in housing can be linked to improvements in schools, safety, job access and transportation.

Some incorrectly believe that higher housing costs singularly affect low-income families. But the reality is that moderate-income families - including teachers, safety personnel, hospital workers and senior citizens - must stretch to make ends meet, let alone afford to own a home. These homeowners often have limited savings and increasingly must rely on adjustable rate loans to afford their initial purchase. A job layoff, a salary freeze or a decrease in retirement benefits could easily result in a mortgage default. This economic pressure is hardly conducive to ensuring a quality of life for the average citizen and makes it increasingly difficult for communities to attract the best and the brightest.

As middle-income families are pushed out of homeownership by increasing costs,

(*Housing Affordability* continued on page 4)

Also In This Issue...

RUNAWAY JURY WAIVERS

pre-dispute waivers may no longer be enforceable under california law

For many years, the real estate industry has taken for granted that pre-dispute jury waivers negotiated in leases, purchase and sale agreements and loan documents will be enforced in California. These waivers have been widely used to resolve disputes by the court, while avoiding many of the potential perils of a trial by jury, such as excessive or inadequate damage awards, jury nullification, bias or prejudice against corporations, delay, inconsistent fact finding, misunderstanding of the law and outright juror misconduct.

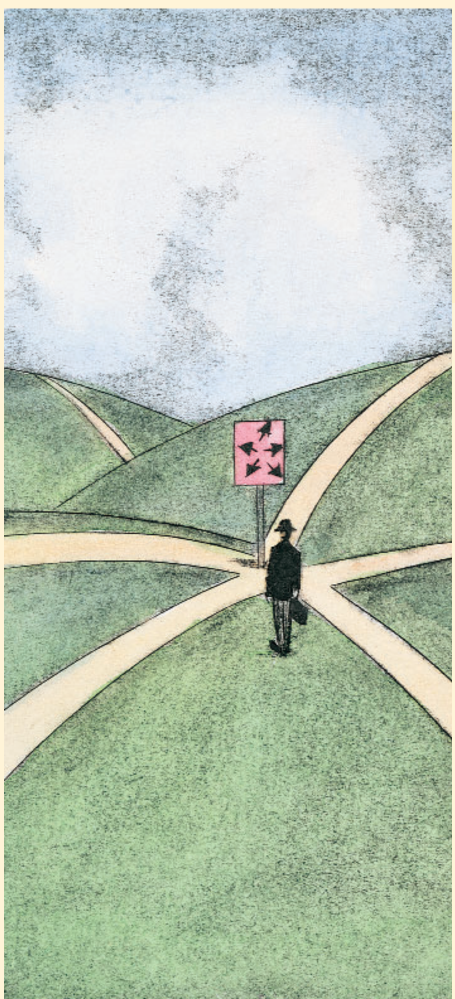
The logic of jury waivers was illustrated in a recent Los Angeles jury trial. In this case, an institutional commercial property owner was the victim of a massive punitive damage award with little supporting evidence. Fortunately, the trial judge overturned the award, finding that not only was there insufficient evidence to support the verdict, but also that the jury's award was the result of "passion and prejudice." According to some of the jurors in that case, there were a number of instances of outright juror misconduct during the trial and deliberations.

This case is but one example of the many instances in California in which institutional and corporate clients, including lenders, investors, property owners and developers, can suffer at the hands of juries. Juries have become notorious for determining the guilt or innocence of the parties based on a perceived disparity of power or money. This predisposition colors jurors' decisions, as does forming a preference for one side over the other for a variety of reasons unrelated to the merits of the case. Real estate participants who do not want to risk such a result understandably opt for jury waivers in their agreements.

THE *GRAFTON* DECISION

However, after the First District Court of Appeal decided *Grafton Partners, LP v. Superior Court*, 2004 WL 226192 (Cal.App.1st Dist.), parties can no longer be certain that jury waivers will be enforceable. On February 6, 2004, the First District held that contractual pre-dispute jury waivers in civil actions are unenforceable under California law.

Until *Grafton*, the courts have enforced such waivers under *Trizec Properties, Inc. v. Superior Court*, 229 Cal.App.3d 1616 (Cal.App.2d Dist.) (1991). In *Trizec*, a landlord and tenant entered into a commercial lease agreement with a provision for both parties to waive their right to a jury trial. The landlord later filed a breach of contract action, alleging that the tenant defaulted and failed to pay basic monthly rent. The tenant cross-complained, alleging constructive eviction and breach of the express and implied covenants of quiet enjoyment. Despite the jury waiver in the lease, the tenant requested a jury trial and the landlord made a motion to strike this request. The trial court denied the landlord's motion to strike on the ground that trial by jury is a constitutional right and that a contractual waiver of that right is void as against public policy. The landlord then appealed the trial court's decision. The Second District concluded that the California Constitution does not prevent individuals from waiving the right to trial by jury in a civil case in advance of any pending action, and, therefore, the contractual pre-dispute jury waiver was enforceable.



The *Grafton* court found that *Trizec* was wrongly decided based on the California Constitution and California Code of Civil Procedure Section 631, which provides only six methods by which a civil litigant can waive (or be deemed to waive) a jury trial. Two of the six ways to waive a jury in the statute are failing to post jury fees in the time required and failing to request a jury at the appropriate stage of the litigation. The statute applies only after a lawsuit is filed in a pending case. The First District reasoned that Article I, Section 16 of the California Constitution requires that the California Legislature dictate the manner in which a jury may be waived, and, to date, it has not articulated any valid forms of waiver other than those listed in Code of Civil Procedure Section 631. While the *Grafton* court relied on decisions dating back to 1855, none discussed pre-dispute jury waivers. Nevertheless, the court concluded that any method of waiving a jury other than those set forth in Section 631, including contractual pre-dispute jury waivers, are unenforceable.

> "The *Grafton* decision... dramatically changes the legal landscape...."

The *Grafton* decision is important because the *Trizec* holding has been relied on in enforcing jury waivers all over the State of California. While the *Trizec* holding continues to be the precedent in the Second District, *Grafton* is now the precedent for courts in the First District. Moreover, courts outside of the First and Second Districts can choose which decision to adopt or make an independent decision based on their own reasoning. The direct conflict between the two appellate districts will require that the California Supreme Court, following its own reasoning, resolve

(*Jury Waivers* continued on page 6)

Time Warner Center

New York's Newest Condo


CAROLINE A. HARCOURT

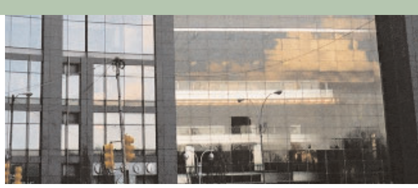

PATRICK J. HENIGAN

February 2004 marked the opening to the public of Time Warner Center, a 2.8 million square foot mixed-use real estate development located in the heart of Manhattan at the southwest corner of Central Park.

Time Warner Center is the largest mixed-use development to be built in New York City since Rockefeller Center. It includes Time Warner's new headquarters; new CNN studios; 200,000 square feet of Class A office space; a 251-room Mandarin Oriental five-star luxury hotel; 198 super-luxury apartments (including a penthouse apartment sold for a reported $45 million); an upscale retail, restaurant and entertainment venue known as The Shops at Columbus Circle; a 1,600-seat performance space for Jazz at Lincoln Center; and a 504 car parking garage.

Because Time Warner Center includes so many component parts and uses, it involved extraordinarily complex ownership and financing arrangements.

Time Warner Center is a 2.8 million square foot mixed-use real estate development located in the heart of Manhattan.



The major stakeholders in the development of Time Warner Center - Time Warner Inc., Mandarin Oriental Hotel and The Related Companies - collectively formed a venture known as Columbus Centre LLC, which held title to the real property during construction. The venture's Operating Agreement governed the stakeholders' rights and responsibilities with respect to the center's development and financing. Columbus Centre LLC purchased the site from the Metropolitan Transportation Authority, and partially financed its purchase with an initial loan from GMAC Commercial Mortgage Corporation. The joint venture then obtained a $1.3 billion construction loan from GMAC to finance the development.

After substantial completion of the project, the ownership structure of Time Warner Center was converted to a commercial condominium regime, in which each component of the project was converted into a separate and distinct fee condominium unit conveyed from Columbus Centre LLC to the applicable stakeholder. One of the many advantages of this condominium structure is that each stakeholder can own its unit in fee simple, thereby making the transferability and financeability of each individual unit more feasible. In addition, the conversion of the Operating Agreement into a condominium structure - wherein the stakeholders took title to the individual condominium units in redemption of membership interests in the LLC - permitted avoidance of transfer tax on the distribution of the individual condominium units.

The principal operating document for the project, on a going-forward basis, is a condominium declaration setting forth the rights and obligations of the condominium unit owners. Among other things, the declaration creates a condominium board through which Time Warner Center is governed, provides physical descriptions of the units and the common elements, provides rights to subdivide and alter a unit, requires unit owner insurance, defines the use (and restrictions on use) of the units and common elements, facilitates the maintenance of the common elements and creates a budget and a mechanism for the payment of all of the foregoing by each unit owner. In this case, the document governs the relationships among no less than six users: the offices, the hotel, the residential apartments, the retail space, the performing arts space and the garage.

One of the many unique aspects of Time Warner Center is that it includes, in effect, a residential condominium within a commercial condominium. The luxury apartment component of the project was initially formed as two distinct commercial condominium units (one each in the north and south towers of the building), and these units were then sub-condominiumized into residential units to be sold to private third parties. Each of the north and south tower residential condominiums will be governed by their own condominium declarations, both acting within the larger commercial condominium that is Time Warner Center.

Pillsbury Winthrop represented Time Warner Inc. in the development of Time Warner Center, including the condominiumization of the Center.

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FROM THE CHAIR


MARY B. CRANSTON

Today's real estate market presents increasingly complex quandaries. As lawmakers and judges race to elucidate areas of uncertainty in the law, new problems of equal or greater complexity are often born.

The articles in this sixth edition of our newsletter illustrate this point. The California Assembly recently endeavored to create laws which would provide relief to residential developers only to find that its new laws imposed a host of new, unintended burdens. Another example is an appellate court's recent ruling regarding the enforceability of jury waivers which appears to fly in the face of a prior ruling in another appellate court in the same state. Similar challenges exist in providing affordable housing and in accommodating increasingly complex title structures. If law firms are not diligent and vigilant in tracking the rapid and often convoluted evolution of the law, attorneys are left scratching their heads, and their clients are left without prudent guidance.

These issues underscore the need for a full-service firm - an amalgam of specialists working together to tackle any challenge in any area of law. Pillsbury Winthrop's Global Real Estate Practice Section is a network of talented specialists armed with the experience and the resources to guide its clients through the complexities of an evolving real estate market.

(*Housing Affordability* continued from cover page)

rental housing is similarly strained by the increased demand. This translates into higher rental rates, which has a domino effect on lower-income families.

The root causes for the lack of affordable rental housing include the rising housing production costs in relation to family incomes, inadequate public subsidies, restrictive zoning practices, adoption of local regulations that discourage housing development, implementation of prevailing wage legislation and loss of units from the supply of federally subsidized housing. Low interest rates and wealth earned in the stock market bubble also helped to drive up home prices. Further, as a reaction against long commutes and large subdivisions, homebuyers and renters rediscovered older, more traditional neighborhoods. This rediscovery caused prices in these previously affordable neighborhoods to increase. Irrespective of the cause, the demand for convenient, affordable housing is not being met.

> "Population growth in the United States will create 13 million to 15 million new households over the coming decade...."

EASING THE STRAIN

Despite the bleak outlook, there are initiatives that can be utilized by the private sector to keep a project's bottom line in the black while also bolstering the supply of both affordable rental and single family housing. Congress, recognizing that the problem of affordability now affects one-quarter of the nation, has implemented incentives to produce new affordable rental housing. The Low Income Housing Tax Credit ("LIHTC") has provided investors with a ten-year stream of credits against income in exchange for producing affordable rental units. Each state is allocated a share of the LIHTC based on its population and is charged with allocating the LIHTC among qualified developers.

In California, for example, the demand for credits usually exceeds their availability by about four-to-one. The California State Treasurer's Office established the Tax Credit Allocation Committee ("TCAC") in order to mete out tax credits. By federal mandate, TCAC adopted the Qualified Allocation Plan, which further refines the selection process for tax credit allocation, giving preference to those developments that encourage smart growth, implement energy efficiency and serve the lowest-income tenants. Preference is also given to those developments where the affordability restrictions will remain in place for the longest period of time.

In New York, tax credits are awarded by the New York State Housing Finance Agency. This state agency has its own Qualified Allocation Plan to allocate tax credits among developers that similarly includes a scoring system that evaluates projects based on location, housing characteristics and the intent to serve a population of individuals with children.

Savvy developers will gear their projects and their LIHTC applications to ensure a tax credit allocation. As much as 100% of a development's construction costs can be financed through a combination of tax credits and conventional or bond financing.

To combat the strain of increasing home prices on homeownership, the newly proposed Homeownership Tax Credit program ("HTC") (which is modeled on the LIHTC program) would allow single family developers of affordable housing to sell tax credits against income for constructing or rehabilitating homes that meet affordable program requirements. If adopted, the HTC legislation is expected to provide $2 billion in new private investment in affordable housing per year. The program targets census tracts with median incomes of 80% or less of the greater of the area median income or state median income. Each state would receive an annual allocation of tax credits starting at $1.75 per capita, subject to a cost-of-living adjustment. For-profit and community-based developers would then receive an allocation of the credits under a competitive process, guided by each state's annual plans for affordable housing. Developers can then sell the tax credits to corporate investors and use the sale proceeds to fund the gap between the cost of development and the price at which the home can be sold to an eligible buyer.

On the local level, municipalities are passing inclusionary zoning ordinances that require developers to include a number of affordable units in new apartment complexes or new developments. In exchange for these set-asides, a developer is eligible to receive land use and planning concessions to offset the cost of the affordable units. These concessions are available to any developer building in the area restricted by the inclusionary zoning ordinance.

Tax-exempt bond financing can also help a multifamily developer tighten the gap between project costs and housing affordability for its tenants. The interest rates on the bonds offered by local government issuers is significantly below the rates offered through conventional institutional financing, even with today's low interest rates. By teaming up with an eligible issuer, a public-private partnership can be formed that will provide the developer with the extra funding needed for an affordable housing rental project.

Another option to developers interested in promoting affordable housing is not so much a financing mechanism, but a land use planning alternative called "smart growth." The smart growth concept centers on policies designed to counteract urban sprawl. These policies include limiting outward expansion, encouraging higher density developments, encouraging mixed-use zoning, reducing travel by private vehicles, revitalizing older areas and preserving open space. While affordable housing is not a direct goal of smart growth, it can be a direct result of the smart growth initiative. The first requirement to smart growth is the recognition of an urban boundary that limits suburbanization. With a firm urban boundary, developers are encouraged to build vertically and to build urban in-fill projects. While construction on greenfield sites away from the core of a city and centers of employment may appear less expensive, the increased den-

(*Housing Affordability* continued on page 8)

Notices of Completion

The year 2004 brought a subtle but important change to California's mechanics' lien law. Under new Civil Code Section 3259.5, for a property owner to shorten the time period for claimants to file liens or related claims, not only must a notice of completion be filed in the applicable county land records, but copies of the notice must also be promptly mailed to the contractor and potential claimants who have served the property owner with a preliminary notice.


ROBERT A. JAMES

Lien law aficionados will instantly grasp the meaning of this change and need read no further. For everyone else, passage of this humble statute is a good opportunity to recap the overall benefits and limitations of completion notices for private owners, and their corresponding impacts on claimants.

To Claim Tomorrow, Identify Yourself Today. Prime contractors, subcontractors, certain suppliers and a number of other types of participants who contribute to the construction of a work of improvement to realty can pursue either mechanics' liens against the property so improved, or "stop notices" against undisbursed funds held by the property owner or construction lender for such improvements. But to exercise such rights, claimants must observe strict notice requirements, including (a) delivering preliminary notices when starting their work and (b) recording lien claims or serving stop notices within a defined time period following completion of the improvement. Each of these requirements is described below.

Preliminary Notices. The owner and any construction lender are entitled to know up-front who may be capable of asserting claims at the end of a project. Potential claimants (other than direct contractors, wage laborers and express union trust funds) must, at the outset of their work, serve a preliminary 20-day notice on the owner, construction lender, prime contractor and any surety to be eligible to later claim a lien or stop notice. The notice is prescribed by statute and widely available as a printed form. Service may be accomplished by personal delivery or by certified or registered mail.

If the notices are not served within 20 days after a claimant commences work on the project, the claimant's lien or stop notice rights only apply to compensation for work performed 20 days before the notices are finally provided. So a subcontractor who starts work January 1, but does not get around to serving its preliminary notices until February 20, can only assert lien or stop notice rights for work performed starting February 1. For its January work, such a tardy claimant is left with only its breach remedies against the party with which it contracted.

Lien Claims and Stop Notices. If a compensation dispute later erupts, a subcontractor's or supplier's lien claim or stop notice must generally be recorded or served no later than 90 days after completion of the work of improvement. Completion is a fuzzy term, defined as any of (a) the owner's occupancy or use of the improvement accompanied by cessation of work, (b) the owner's acceptance of the work or (c) cessation of labor on the work for 60 days. Under California case law, completion has been found where the remaining punchlist work was to replace items that were defectively installed, but not where the remaining work was original installation of a specified item, even as trivial as soap dispensers or a second coat of paint. Owners should consider making a formal acceptance of the work (reserving all of their warranty and contract rights), as this test is the clearest option provided in the statute.

In addition to the difficulty in defining completion, the 90-day period is a long time for owners or lenders to be exposed to claims. They normally insist on retaining portions of the contract price as security for the full period of exposure, which is not in the contractors' interest either.

The Completion Notice. From the owner's and lender's standpoint, the 90-day period of exposure to claims can be considerably shortened and clarified by properly using a notice of completion. A properly recorded notice of completion can reduce the time period for subcontractors and suppliers to record lien claims or serve stop notices from 90 days to only 30 days. Moreover, the 30 days is

(*Completion Notices* continued on page 8)

(*Jury Waivers* continued from page 2)

this issue on a statewide basis. The California Supreme Court review process could take more than a year. In the meantime, those doing business in California who desire a sense of certainty in avoiding a jury must take immediate measures to protect themselves.

IMPLICATIONS OF *GRAFTON*

The *Grafton* decision not only renders existing contractual jury waivers potentially unenforceable, but it also dramatically changes the legal landscape for future commercial real estate contracts and related disputes.

Parties to an existing agreement that contains a pre-dispute jury waiver should reassess their rights under the contract and reevaluate their relationship with the other contracting party or parties. For example, in the past, a party may have chosen to commit a knowing breach of such a contract if the profits were expected to exceed the cost of the breach. The potential cost of the breach would include a relatively fast and inexpensive trial without a jury. In a post-*Grafton* environment, the cost of a breach may now be significantly greater. Even plaintiffs do not escape the reach of the *Grafton* decision, as the cost of litigation in general may be much higher than previously anticipated once a jury is involved.

Parties to an existing contract engaged in a dispute that has not yet reached the stage of litigation should also reexamine their strategy for resolution in the face of *Grafton*. If the agreement would be litigated in California and in the First District, the parties may wish to amend their agreement to provide another venue to avoid the imposition of *Grafton*. As experienced practitioners know, it is nearly impossible to amend an agreement in dispute unless all parties perceive a similar risk in not amending the agreement. In the absence of that mutual perception, the amendment process will become expensive to the party who must persuade the other to amend the agreement before litigation. If the agreement is not amended, once a dispute arises, settlement may present a more appealing option than the alternative of a jury trial, with its potentially higher costs to defend and higher damage awards for a sympathetic plaintiff.

For real estate participants commencing a transaction in a post-*Grafton* environment, parties to a transaction may have to live with either arbitration or a jury trial if a dispute arises, which changes the implications of both contractual commitments and the litigation of contractual disputes. Before entering into an agreement, parties may now have to include provisions previously considered unnecessary to protect their interests in the event of a breach, such as provisions to limit or eliminate certain kinds of claims or damages or to define terms such that liability may be based on the actual knowledge of particular individuals. The more limited options for dispute resolution may force parties to consider promising less ambitious performances under contracts if there is uncertainty about the parties' ability to fulfill the terms. When deciding whether to seek arbitration, pursue litigation aggressively or settle a case, the potential for large jury awards should be considered.

POST-*GRAFTON* OPTIONS

Grafton will impact parties to real estate contracts for some time to come by changing the options available for risk management and dispute resolution. For instance, parties may choose to opt out of the court system

(*Jury Waivers* continued on page 7)

REAL ESTATE what it means

by Robert M. Haight, Jr.

An expert is one who knows more and more about less and less. This humorous, but glib, way of explaining the age of specialization comes courtesy of Nicholas Butler, Columbia University's president for most of the first half of the 20th Century. In our modern, complex business world, it is neither economical nor prudent to hold oneself out as an expert in all areas of a chosen profession. This is especially true in law, where the consequences of inexperience can be costly to both client and lawyer alike. Thus, most lawyers practice in a specifically-defined legal field. Law firms, too, tend to specialize in one or more defined legal fields.

over 70
real estate lawyers

In recent years, however, more and more law firms are consolidating, either through merger or by acquiring select practice areas of other firms. In fact, according to The Hildebrandt Institute, law firm merger activity has soared over the last 6 years in firms of all sizes, the gap between large- and mid-sized firms has widened and there is evidence that premium work has migrated towards larger law firms. As of October 2003, 92 U.S.-based firms boasted more than 400 lawyers.

The reasons for this consolidation trend are varied, but one reason is a response to clients who are seeking firms that can provide so-called one-stop shopping. Indeed, clients are tightening their outside counsel referral lists and looking for firms that can serve them in a variety of legal and geographic areas. Through consolidation, many law firms now purport to be full-service firms.

But, in the case of real estate lawyers, what does it mean to be part of a "full-service" firm?

To answer this question, one need only look at the Global Real Estate Practice Section of Pillsbury Winthrop. With over 70 real estate attorneys in 10 offices across the United States, the Global Real Estate Practice Section prides itself as an integral part of a full-service law firm with over 750 lawyers in 16 offices across the world. In analyzing the Global Real Estate Practice Section in particular, and the firm in general, four concepts emerge in Pillsbury Winthrop's ability to provide comprehensive legal services. The four concepts, or keys, to a full-service firm are geographic diversity, sub-practice area diversity, appurtenant practice area diversity and technological and structural linkage. Set forth below is a discussion of each of the four keys, with Pillsbury Winthrop used as an example to illustrate the concepts discussed.

Geographic Diversity. One of the hallmarks of a large law firm is maintaining offices in several geographic locations. While technology often makes geography academic, clients prefer to engage a law firm that has connections to its corporate or regional headquarters and to the area in which the real estate transaction is to occur. Often, but not always, these are the same

global presence
cross discipline

place. Although it is not possible or desirable to have offices in every real estate market, concentrating on key markets can lead to success. This is equally true for clients who will set up regional offices in key markets and then provide services in several surrounding cities and states. As an example, Pillsbury Winthrop's Houston office was selected, in part, due to the location of some of the Global Real Estate Practice Section's clients, such as ChevronTexaco Corp. With foot-

PRACTICE: to be full-service

prints in several key cities, the Global Real Estate Practice Section has provided services to clients from Hawaii to Texas to Connecticut, and many points in between.

16 worldwide offices

Sub-Practice Area Diversity. Just as a large law firm can be made up of several practice areas, so can a practice area such as real estate be made up of several sub-practice areas. For example, Pillsbury Winthrop's Global Real Estate Practice Section consists of attorneys accomplished in purchases and sales, real estate litigation, public finance, land use, leasing, construction lending and project development. Clients' real estate needs are varied and complex, and to provide them with full service, a law firm offering real estate services must offer most, if not all, of the various sub-practice areas.

Appurtenant Practice Area Diversity. A typical real estate transaction today involves multiple disciplines - it is a legal octopus, with tentacles grasping elements of litigation, bankruptcy, tax, political law and securities in addition to real estate. These multiple disciplines may be sought by clients consecutively, as when during the course of a real estate matter a party declares bankruptcy or an IRS letter arrives. More often, however, these multiple disciplines are required by clients concurrently, to, for example, account or prepare for the bankruptcy of a party or to avoid IRS scrutiny.

Without a diversity of practice areas, clients may be forced to hire several law firms as issues arise. In such a case, clients risk lack of coordination among attorneys due to different law firms. In addition, when multiple law firms serve clients on the same matter, there is always the risk of one-upsmanship, whereby one law firm seeking future business from the clients competes with the other law firms instead of working cooperatively.

With clients looking for one-stop shopping, a firm like Pillsbury Winthrop - offering a cadre of attorneys versed in tax, litigation, political law, corporate and securities, entity formation, employee benefits, bankruptcy and creditor's rights - will be able to meet the clients' needs.

Technological and Structural Linkage. Implicit in the concept of one-stop shopping is coordination among the various practice areas. Large, multi-disciplined law firms like Pillsbury Winthrop are technologically and structurally linked. Through state-of-the-art hardware and software, geographically diverse offices can be connected seamlessly through computer and telephone networks. Managing business units - whether practice areas or client teams - allows for strategic planning and coordination. Each of these "links" provides the inter-disciplinary coordination that is essential to properly serve clients. Pillsbury Winthrop's motto - Teams That Work - recognizes the technological and structural linkage necessary in today's legal environment.

The global nature of our economy, the ease of travel and the technological advances that connect people in disparate places have led to businesses of all sizes in need of comprehensive legal services, including real estate. A full-service law firm with a real estate practice - especially one that implements the four concepts discussed above - is best positioned to deliver those legal services.

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(*Jury Waivers* continued from page 6)

entirely and choose binding arbitration, which, so far, represents an enforceable pre-dispute agreement. The California Supreme Court, in a case on which the *Trizec* court relied, has held that arbitration agreements do not violate either the constitutional or the statutory protections of the right to a jury trial. *Madden v. Kaiser Found. Hospitals*, 17 Cal.3d 699, 713 (1976). Parties can therefore reasonably rely on enforcing their arbitration agreements under federal and California arbitration statutes. This is the case only if they limit the involvement of the court system to confirming the arbitration award and reducing it to a judgment.

> "*Grafton* will...[change] the options available for risk management and dispute resolution."

If parties opt out of the court system entirely using a binding arbitration clause, they must carefully tailor the arbitration clause to their needs. Many in the real estate industry have horror stories of arbitration experiences or results. Some of the problems can be eliminated if the parties know what to expect and draft their agreements accordingly. Parties should specify, at a minimum, the forum, rules, time requirements, procedural requirements and enforcement.

Another dispute resolution alternative is reference and the use of a referee pursuant to California Code of Civil Procedure Section 638. Reference is a relatively simple process which is an intermediate step between arbitration and litigation. Typically, a lawsuit is filed and the court determines that there is a valid agreement to submit to a referee, usually a retired judge or real estate practitioner and usually preselected by the parties in their agreement. Unlike binding arbitration, the reference system allows the parties to utilize the court system and the litigation process fully, including appeal. Continued use of this procedure, even after *Grafton*, should be safe, because the parties are using a specific statutory scheme.

Although the alternatives to a bench trial are not perfect, arbitration and reference proceedings offer some level of control and protection to parties when they need to resolve disputes. Parties can present their evidence, obtain a ruling on the merits and, in most cases, appeal the final decision. Additionally, even considering the sometimes-scant civil background of judges and arbitrators, parties are more likely to achieve a result founded in law and fact, rather than a decision based on a predisposition and bias.

BOILERPLATE NO MORE

Prior to *Grafton*, parties to real estate transactions structured their agreements with the certainty of jury waivers, often relegating dispute resolution provisions to boilerplate. With the *Grafton* decision, and the possible change in the scope of potential damages, parties to agreements under California law now must consider the relative merits of various dispute resolution options. In addition, until the matter is resolved by the California Supreme Court, the venue for dispute resolution takes on greater importance. While contracting parties can tailor a dispute resolution clause to suit their respective needs, they cannot provide with any confidence for a process which includes a jury waiver.

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(*Housing Affordability* continued from page 4)

sities found in smart growth developments can help spread the costs of land, environmental remediation and infrastructure over a larger number of housing units. Accordingly, these units can be sold at prices that are competitive with, if not lower than, those projects built on greenfields. Smart growth development of this type is additionally beneficial to local communities because the developments are located close to jobs, which in turn reduce housing and commuting expenses. The community is also a beneficiary of smart growth development as the reduction in brownfields, the remediation of pollution and the decrease in traffic improve the quality of life for the citizens of that community.

> "As much as 100% of a development's construction costs can be financed through a combination of tax credits and conventional or bond financing."

LIFTING THE CLOUD

Population growth in the United States will create 13 million to 15 million new households over the coming decade, creating a need for homebuilders to construct about 1.6 million new homes each year during that same period. These numbers do not account for the millions of rental units and single family homes that this country needs to provide to catch up with the lack of affordable housing supply on the market. While the obstacles to the provision of affordable housing are formidable, through successful public-private partnership arrangements, land use and financial incentives, developers, cities and states can lift the cloud for the more than 28 million Americans who face limited access to decent, safe, affordable housing.

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(*Completion Notices* continued from page 5)

measured from the precise date the notice of completion is recorded, rather than the imprecise date of actual completion.

The 30-day period is why so many California construction contracts provide for final payment to the prime contractor a mysterious 35 days after final completion. The 35-day period affords owners an opportunity to record a completion notice, wait 30 days for liens to be filed, then check the land records for lien recordings -- all before letting go of the undisputed retained funds.

The notice of completion is fairly simple. The owner need only certify the completion date, the owner's name and address, the owner's estate or interest in the realty (e.g., fee, leasehold or easement), a description of the site (not necessarily a legal description) with the street address and the name of the prime contractor. The owner's signature on the notice is verified (i.e., signed once, then signed again under penalty of perjury), not acknowledged before a notary public.

The upside to an owner of recording a valid completion notice is, of course, that the exposure to lien and stop notice claims is extinguished after 30 days. The downside is that the owner trades the shorter time period for the possibility that such public notice will attract claimants who might not otherwise make a timely filing.

To benefit from the shortened 30-day period, completion notices must be recorded within the 10-day period following actual completion (as defined in the statute). If not timely recorded, the completion notice is generally of no effect, and all claimants have the full 90-day period following actual completion to record liens and serve stop notices.

> "The upside to an owner of recording a valid completion notice is, of course, that the exposure to lien and stop notice claims is extinguished after 30 days."

DON'T FORGET THE POSTAGE STAMP

Commencing in 2004, Section 3259.5 requires that the owner send notice of the recording of the completion notice, both to the prime contractor and to anyone who has served a preliminary notice, within 10 days of recordation. The notice may not be accomplished by personal delivery (unlike for preliminary notices), but must be sent either by registered or certified mail, or (unlike for preliminary notices) by first-class mail, evidenced by a certificate of mailing.

If this notice is not sent promptly to any given claimant, the completion notice does not shorten that individual claimant's time period, and it has the full 90-day period (this time, measured from recordation of the completion notice) to record its lien claim or serve its stop notice. It is not clear what minimum information must be in the notice required by Section 3259.5, but a copy of the completion notice bearing the recordation date would presumably satisfy all requirements.

NEED FOR NOTICE AND FINALITY

Section 3259.5 is the product of construction claimants' latest attempt to ensure being advised of lien deadlines. Previously, claimants had to protect themselves, either by subscribing to a service that reports daily recordings of completion notices in a given county, or by electing to require the county recorder to alert them of filings on a given project. With Section 3259.5, the burden of alerting claimants is now imposed on those owners who want the benefit of the early time cutoff afforded by completion notices.

The California mechanics' lien law is a curious blend of broad equitable principles and strict legal formalities. The general goal of enhancing the payment prospects of those who improve property is set off against the need for finality and order in real estate construction and finance transactions. Changes to the rules, even ones as incremental and modest as the new statute, are best understood in light of those policies.

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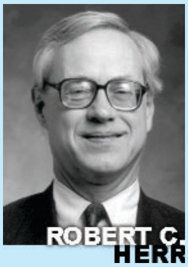
Making Financing Easier (maybe)



Last year, California's residential developers secured some modest relief from the State's notoriously strict regulatory climate - or so they thought. Assembly Bill 728 ("AB 728"), which became effective January 1, 2004, aimed to encourage more favorable financing from lenders, thereby spurring development of badly needed housing. Specifically, the bill aspired to help developers pre-sell certain units of attached condominium housing (that is, to enter into binding contracts with buyers before construction has been completed) and retain a larger portion of a buyer's deposit in the event of breach. AB 728 presumes that pre-sold units improve project viability which makes lenders more apt to finance the development. However, while its intentions may have been on target, the new bill appears to have missed its mark.

Identifying the Problem. In California, the sale or lease of subdivisions of five or more units falls under the jurisdiction of the Department of Real Estate ("DRE"). In the interest of consumer protection, California law requires the issuance of a final public report by the DRE before any subdivision under its jurisdiction may be offered for sale or lease. The final public report discloses valuable information to the potential purchaser, including covenants, conditions and restrictions, costs and assessments for maintaining common areas, a detailed subdivision map and conditions of sale. The purpose of the public report is to protect the consumer from misrepresentation, deceit and fraud in the public sale or lease of subdivisions.

While a final public report is required before a sale or lease is complete, the DRE also issues conditional public reports pursuant to Section 11018.12 of the California Business and Professions Code. Conditional public reports permit developers to enter into binding contracts with buyers, subject to satisfying certain specified conditions. Before closing, all conditions must be satisfied and a final public report must be issued that is not materially different from the earlier conditional public report. Prior to the passage of AB 728, conditional public reports were valid for a period of six months, with a possible six-month extension. Ostensibly, conditional public reports allow developers to enter into binding contracts while construction is underway and before a final public report has been issued. While this system may have had consumer interests in mind, its application has proven harmful to consumers by making construction of attached condominium housing more costly and, therefore, more difficult.

> "The inadequate one-year period results in more conservative lending at higher prices, which discourages new projects and limits the availability of housing."

To secure favorable financing, developers need to minimize lenders' risk by demonstrating project viability through the existence of binding contracts with buyers. However, the reality of attached housing is that completion of development and construction most often takes more than the 12 months permitted under the prior law. According to the Senate Local Government Committee, "getting a final subdivision map under the [Subdivision] Map Act can take several years, [so] having a one-year conditional report isn't enough time." After the one-year period, the conditional public report expires and buyers can terminate their contracts - not the kind of risk-reduction most lenders seek. The inadequate one-year period results in more conservative lending at higher prices, which discourages new projects and limits the availability of housing.

In addition, in the event of a termination by buyers, sellers would normally look to the liquidated damages clauses in the purchase contracts for their remedy for breach by the buyers. Before adoption of AB 728, Section 1675 of the California Civil Code limited the amount of liquidated damages developers could receive in the event of a breach. Specifically, if the damages did not exceed 3% of the purchase price, they were considered valid unless the buyers established that the amount was unreasonable. Conversely, if the damages did exceed 3%, the provision was presumptively invalid unless the sellers could establish that the amount was reasonable. The difficulty of securing a significant portion of the deposit contributed to uncertainty, which, in turn, discouraged lending.

Fixing the Problem. In response to these concerns, California enacted AB 728, thereby amending Section 11018.12 of the Business and Professions Code and Section 1675 of the Civil Code. The bill implemented two major changes to address the difficulties of securing financing for certain developments. First, it extended the period for conditional public reports to 30 months for attached residential condominium housing of 25 or more units, with a possible six-month extension, for a total of 36 months. Second, it introduced a new formula for evaluating liquidated damages clauses for the initial sale of units in projects with 10 or more units. Amended Civil Code Section 1675 now provides that when buyers pay more than 3% of the purchase price as liquidated damages, the sellers must prepare an accounting of their costs and revenues allocable to the construction and ultimate sale of the unit, including costs related to the buyers' default, with-

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Complex Title Structures
Send Lenders "BACK TO BASICS"

MAX FRIEDMAN

BARRY LANGMAN

The typical non-recourse real estate loan is easy to describe. The borrower is the owner in fee simple of a piece of property. A lender agrees to lend money to the borrower, after satisfying itself that the value of the property is sufficiently greater than the loan the borrower seeks (to comply with the lender's required loan-to-value ratio) and performing other customary physical and documentary due diligence with respect to the property. The loan is secured by a mortgage on the property and other security documents, and the mortgage is recorded in the appropriate local land records. The borrower makes payments of interest and principal to the lender until the loan is paid in full, at which time the mortgage is released of record. While this description vastly oversimplifies most commercial real estate loans, in recent years the level of variation from this archetype has increased markedly, creating challenges for both lenders and their counsel.

Many of these challenges are the result of more complex debt structures. Lenders may spread credit risk by creating syndicates of multiple institutions or participating out portions of the loan. Loans may be segregated into tranches with various interest rate types and periods. The borrower may be required to enter into interest rate collars and caps in order to provide protection against fluctuations in interest rates over the term of the loan - often secured on a parity basis with the loan itself. Subordinate loans may be provided, including mezzanine loans secured by equity interests in the borrower itself. Intercreditor agreements of varying complexity may be required.

However, lenders are increasingly finding that the structures that complicate mortgage loans are arising on the borrower's side as well. As developers and other borrowers seek to achieve various tax or business goals, they may split title interests in various ways such that lenders do not hold a mortgage or deed of trust on the standard fee simple interest. In those instances, lenders need to analyze how the intricacies of a divided title structure can affect the loan and the lenders' security.

> "Understanding that their security is as much paper as property, and proceeding accordingly, lenders can avoid unpleasant surprises down the road."

A typical (and relatively commonplace) example is a ground lease structure. Perhaps the developer or a tenant obtained tax benefits that require that fee title be held by a governmental agency and leased back to the beneficial owner. Such a mechanism would likely involve payments in lieu of taxes (PILOT) that might differ significantly from the general tax structure with which lenders are familiar. Alternatively, the ground lease might be from a private-sector landowner that wishes to receive ground rent payments instead of selling the property, but wants to maximize the value of the property by having a third party develop it. In each case, lenders need to satisfy themselves (in addition to the inclusion of suitable mortgagee protective provisions) that the other provisions of the ground lease - including provisions as to use, assignment, casualty and condemnation - satisfy the standards for a financeable ground lease.

Another increasingly common example occurs in multi-use development projects involving separate retail, entertainment, office and/or residential components. These properties are often subjected to condominium regimes, sometimes before construction is completed. While the condominium structure enables each of the various segments to be held in separate ownership, it requires that lenders (as in the ground lease context) analyze not only any mortgagee protective provisions in the condominium documents, but also the various rights and obligations to which each unit owner is subject. In that regard, lenders will need to determine whether renegotiation of those rights and obligations is necessary (and feasible) to provide lenders with suitable security for their loans.

A further example, which lenders are increasingly facing in the residential context, is property that is the subject of sophisticated estate planning. Title companies report seeing more life estates, fees on limitation and other structures that most lawyers thought they left behind at the bar exam. Other structures of growing popularity are family limited partnerships, and the alphabet soup of QPRTS, GRIC's and GRAT's.

As loan structures move further and further from the fee simple model, complex title arrangements require that lenders analyze the documentary structure creating the estate as carefully as the property itself. In short, lenders must not lose sight of the fact that their security is technically the rights afforded to their borrower under the documents creating the borrower's estate in the property, not the property itself. In other words, lenders' rights are never greater than the instruments creating the borrower's interest. In this regard, provisions that contradict or otherwise are not in accordance with those in the loan documents can radically alter the arrangements that lenders intended to be in place.

Since the loan documents cannot, standing alone, alter the underlying arrangement between the borrower and other interest holders, lending against complex title structures often necessitates the negotiation of agreements with other interest holders - ranging from amendments to condominium structures, subordination and non-disturbance agreements with ground lessors and consents from other tenants-in-common. Each situation will require unique crafting, since each set of underlying or operative documents is likely to differ. Care also needs to be taken in the recording of these documents, to insure that the lenders' successors and assigns are afforded the benefit of the protections negotiated with third parties, and that the appropriate estates - which may exceed the borrower's estate in the property - are bound by the agreements.

> "[L]enders' rights are never greater than the instruments creating the borrower's interest."

The confusion which arises in lending against an estate short of fee simple is demonstrated clearly by the misuse of the concept of subordination. It is not uncommon to read in a ground lease that the fee and the fee mortgagee will not be "subject and subordinate" to a leasehold mortgage. As to the fee itself, the ground lease is presumably saying that the fee interest will not be encumbered by the leasehold mortgage. As between a fee mortgage and a leasehold mortgage, the concept of subordination is actually a misnomer, since the two mortgages are on entirely different estates.

Understanding that their security is as much paper as property, and proceeding accordingly, lenders can avoid unpleasant surprises down the road. Lenders in complex title scenarios may never have the clarity of a fee simple interest, but a clear-eyed view of the security they do have can indeed be quite valuable.

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in 60 days of the unit's final sale. Sellers must refund any amount in excess of either 3% of the purchase price or the sellers' losses resulting from the buyers' default, as calculated by the accounting, whichever is greater. In theory, then, sellers could retain more than 3% of the purchase price.

Missing the Mark. At first glance, extending the total permissible term of the conditional public reports from 12 to 36 months appears to ameliorate somewhat the financing problems outlined above. If developers have more time to complete the project and receive the final public report, there is less risk of buyers backing-out of contracts. However, AB 728's attempted solution appears to have overlooked a separate California law: Civil Code Sections 2985-2985.6. These sections provide criminal penalties for sellers who encumber property under contract for sale where the contract contemplates closing outside of one year. In order to prevent application of the foregoing sections, real property sales contracts would have to include provisions requiring a return of the buyers' deposit before the close of one year, unless the buyers agree at that point to extend the deal. This one-year limitation conflicts directly with the goals of the new 36-month time frame for conditional public reports.

In addition, the new formula for calculating liquidated damages does not appear to provide much relief for developers. To begin with, developers now have the burden of performing an accounting of their loss. Second, AB 728's definition of loss neglected to include the developers' anticipated profits, which is the traditional method of calculating damages for breach. Instead, the developers will only recover their "losses" to the extent that the price they receive from subsequent buyers is below the developers' actual cost. In other words, developers cannot recover their lost profit in the event of buyers' breach. Instead, developers can only recover their out-of-pocket costs, likely to be less than the amount paid by subsequent buyers, resulting in retention by sellers of no more than 3% of the first buyers' purchase price as liquidated damages. In the end, developers are actually in a worse position under the same circumstances than under the prior law.

Filling the Gap. While it remains to be seen whether AB 728 will have any appreciable impact on lending and development, additional legislation may be necessary. Certainly, all parties would benefit from some clarity regarding whether binding contracts covered by public reports can contemplate closing outside of 12 months. In addition, if the California Legislature was willing to grant more freedom to buyers and sellers to negotiate liquidated damages clauses, it may want to revisit whether its new formula will achieve the desired result. Until such clarification arises, developers need to be aware of both the criminal penalties which could arise from violating the one-year limitation contained in the Civil Code and the limitations on liquidated damages.

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PILLSBURY WINTHROP DEBUTS ON BROADWAY
new york office relocates

After 135 years in the Wall Street area, in January 2004 the New York office of Pillsbury Winthrop moved to new space at midtown Manhattan's Bertelsmann Building at 1540 Broadway. The new office is located in Times Square, a neighborhood undergoing revitalization through an urban renewal project on which the firm's real estate attorneys have participated for over 20 years as counsel to the New York City Economic Development Corporation. The move marks a reaffirmation of Pillsbury Winthrop's commitment to New York City and optimizes access to the firm's national and international client base.

"The move of our office to Times Square is a strategic business decision that allows us to offer the quality service that our clients expect along with a more efficient office space," says Donald G. Kilpatrick, one of the partners who oversaw the relocation. "When Winthrop merged with Pillsbury three years ago, we added a broader and deeper national and international client base. Our new location in the heart of Times Square will not only permit us to better meet client needs, but will also allow us to continue to participate in the revitalization of this area."

At the new space, Pillsbury Winthrop will occupy more than six floors, encompassing approximately 180,000 square feet and accommodating up to 225 attorney offices. The 42-story Bertelsmann Building, built in 1990, features a distinctive tower of green glass, aluminum and stainless steel and provides dramatic views of Times Square, the Hudson River and New York landmarks such as the Empire State and Chrysler Buildings. The Bertelsmann Building also houses the U.S. headquarters of Bertelsmann AG, the third-largest media company in the world.

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