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Perspectives
on Real Estate

Our Real Estate Practice provides legal services to real estate professionals across the globe

Article Highlights

For more information on Pillsbury's Real Estate Practice, please contact:

William S. Waller
213.488.7326
william.waller@pillsburylaw.com

John Engel
202.663.8863
john.engel@pillsburylaw.com

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In Order to Win, You Must Participate

by James M. Rishwain, Jr., and Stacey L. Hall

Pick up any newspaper, turn on any news station or browse any website, and the consensus is clear: These are dire financial times. The U.S. economy is facing tremendous headwinds and challenges the likes of which have not been seen since the Great Depression. The subprime mortgage meltdown has decimated residential real estate, leaving more than 10 percent of U.S. homeowners with no equity in their homes, and the numbers are ominously mounting as residential property values continue to tumble.

As the credit crunch continues, investors must seek out alternative means to finance their commercial real estate projects.

Despite the recent turmoil in the residential real estate market, the picture for commercial real estate looks relatively rosy. While that may sound overly optimistic, consider the following factors: The demand for central business district office buildings, resort hotel projects and other well-positioned commercial properties still outweighs supply; interest rates on loans for real estate remain at historically low levels; and institutional investors,

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In Order to Win, You Must Participate

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pension funds and sophisticated real estate developers are awash in capital as folks were fleeing the stock market even before the recent market downfall.

So, what is the problem in an environment in which there are historically low interest rates, a strong demand and tremendous capital? The credit crunch! Simply stated, there are not enough benefits and rewards to outweigh the risks for lenders to lend. Banks and brokerages have tightened lending standards and made it difficult for commercial borrowers with even excellent credit to get a loan.

As the credit crunch continues, investors must seek out alternative means to finance their commercial real estate projects. One particularly noteworthy alternative financing mechanism exists that has been sitting unused in the marketplace toolbox for many years. The tool is called the participating mortgage.

A participating mortgage is a loan in which the lender lends at a fixed rate of interest and supplements it with a "participation," usually expressed as a contingent interest, in the cash flow from operations and/or appreciation in value of the underlying property. Despite seeming relatively simple, participating mortgages are highly complex instruments. Specific participation features and mortgage terms are usually heavily negotiated and unique to each transaction structure.

An Old Tool Put to New Use

Participating mortgages have historically been used as popular financing tools during periods of high interest rates. In the early 1980s, for example, high interest rates made real estate development too expensive for many investors. With the participating mortgage, however, lenders were willing to lend money at a lower fixed interest rate in exchange for a participation in the profits of the property, thereby enabling investors to undertake real estate projects that otherwise would have been unaffordable.

The market today is certainly much different than it was in the 1980s. However, the benefits of the participating mortgage remain the same. Participating mortgages provide today's risk-averse lenders with a critical incentive to extend credit by enabling them to receive, in addition to a fixed rate of return, a participation in the current cash flow and future appreciation of the underlying real estate. Great reward comes with great risk, however, and lenders and borrowers alike must be aware of several important legal considerations before entering into a participating mortgage.

Characterization as a Partnership

The biggest risk with a participating mortgage is that the relationship between the lender and the borrower could be characterized legally as a partnership. If this occurs, the lender could become jointly and severally liable for the debts of the borrower incurred on behalf of the partnership, including the claims of third parties against the partnership.

Participating mortgages provide today's risk-averse lenders with a critical incentive to extend credit by enabling them to receive, in addition to a fixed rate of return, a participation in the current cash flow and future appreciation of the underlying real estate.

In structuring a participating mortgage, it is essential to be aware of the factors that could cause the relationship between the lender and the borrower to be characterized as a partnership. The Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on, as co-owners, a business for profit." Courts generally look to four factors to determine whether a partnership exists: (1) the intent of the parties; (2) the sharing of profits; (3) the sharing of losses; and (4) the degree of control of the parties over the affairs of the enterprise.

The intent of the parties is paramount. If the parties truly intend for the relationship to be a partnership and are using the loan documents as a means by which they are creating form over substance, the relationship is at serious risk of being characterized as a partnership. In order to mitigate against this risk, the loan documents must, at a minimum, contain an explicit disclaimer of any intent to form a partnership relationship between the borrower and lender.

The sharing of losses is another major red flag. If the lender bears responsibility for even a part of the borrower's losses, this will automatically trigger a partnership characterization. The last two factors are questions of fact. Courts look at the extent to which the lender is involved in the day-to-day operations of the enterprise and its level of participation in the profits of the project to determine whether a partnership relationship exists. The lender must always act as a lender and never as an owner.

Usury

Another risk with the participating mortgage is that it may potentially violate state usury laws. Under a participating mortgage, the amount of contingent "participating" interest the lender receives may be added to the fixed rate of interest for purposes of determining whether the loan is usurious. When aggregated, the total interest may exceed the usury limit.

A careful examination of the state's usury laws (and any exemptions thereto) by the real estate lawyers involved in the transaction is essential when structuring a participating mortgage.

Structuring Approach

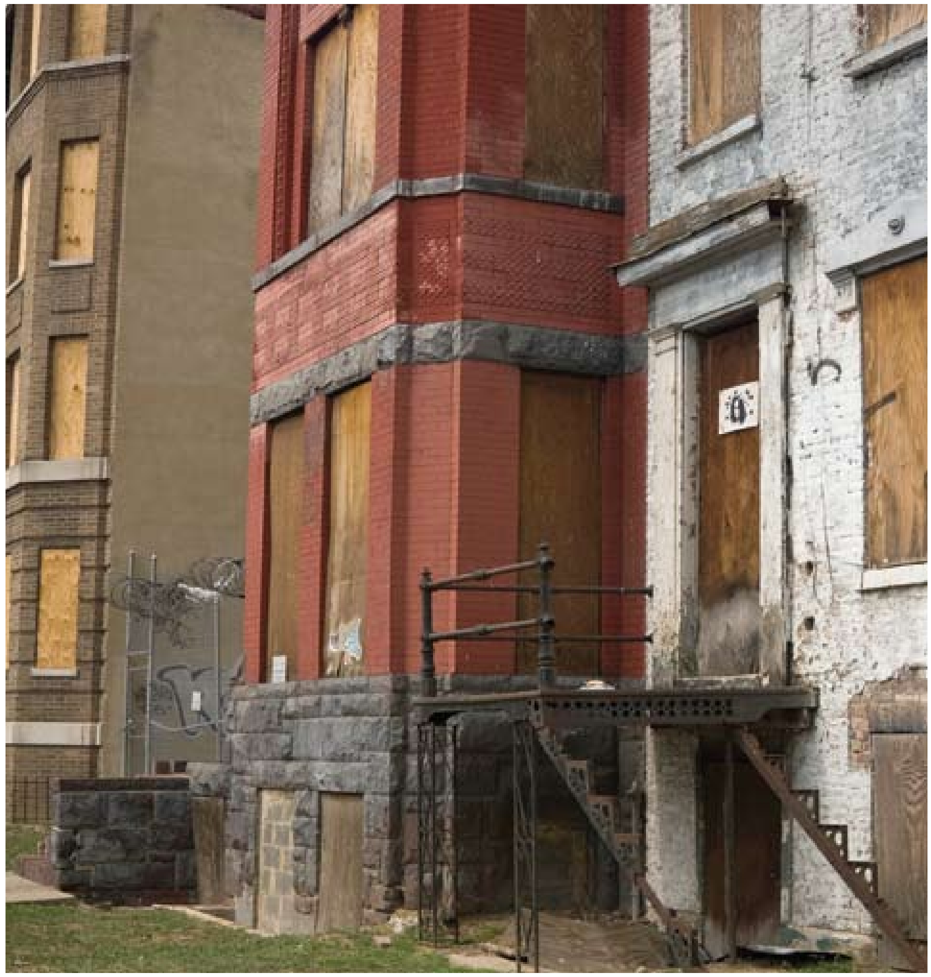
We have discussed two fundamental concerns related to participating mortgages, namely characterization as a partnership and potential violation of usury laws. In consideration of these concerns, we recommend that you look at these loans as having two fundamental components. The first component is the actual loan itself, which we will label the hard money loan. The second component is the portion that represents the lender's right to participate in the net income or profits from the project. We will call this the participating portion. In structuring these loans, in order to protect and preserve the hard money loan, we recommend that it be documented with a separate promissory note secured by a first deed of trust. With the same logic in mind, we recommend that the participating portion be documented by an independent note secured by a second deed of trust. By so doing, in the event that issues of enforceability arise in connection with the participating portion, it should not affect the enforceability of the hard money loan, which is documented by a separate note secured by a first deed of trust.

Re-emerging Trend

The participating mortgage is a lending tool of the past that is worthy of serious consideration in today's credit-tight market as a way to help infuse capital into real estate development. The participating mortgage gives the lender an incentive to participate by giving more rewards to offset the high risks. If you do not participate, you cannot achieve the gains you will need to succeed. Lenders, even in this economic environment, it is time to participate!

James M. Rishwain, Jr.
is Pillsbury's firm chair and a partner in the Los Angeles office. He can be reached at 213.488.7111 or jrishwain@pillsburylaw.com.

Stacey L. Hall
is an associate in Pillsbury's Los Angeles office. She can be reached at 213.488.7152 or stacey.hall@pillsburylaw.com.



Eminent Domain Post-*Kelo*

by Deborah B. Baum and David Tabibian

The Supreme Court's 2005 decision in *Kelo v. City of New London* was no doubt one of the most controversial high court decisions of our time. Politicians and citizens alike quickly expressed their distaste with the ruling. The Court in *Kelo* upheld a local government's right to take private property and transfer it to another private owner for economic development purposes as a proper "public use" under the Fifth Amendment without showing that the property was blighted. *Kelo*'s holding was predicated, however, on the city's proffer of a comprehensive development plan and a showing that the taking was necessary to the fulfillment of the plan. The decision left the door open to application of heightened scrutiny where the "economic development" rationale was challenged as a mere pretext for a different, improper purpose.

Rather than broadly easing the use of eminent domain to further economic development projects, however, *Kelo* spurred a wave of state legislation enacted to limit the use of the state's power of eminent domain in other than "traditional" public uses. Moreover, in the cases that followed *Kelo*, while some decisions are based on a direct application of *Kelo* analysis, they often turn largely on the relevant jurisdiction's legislation. As a result, the law in this important area remains somewhat unsettled.

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Eminent Domain Post-*Kelo*

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Significant Post-*Kelo* Court Rulings

In *Western Seafood Co. v. U.S.* (2006), a case with similar facts to *Kelo*, the Fifth Circuit permitted the city of Freeport, Texas, to condemn riverfront land owned by a private company that provided services to commercial shrimp trawlers. Following the reasoning in *Kelo*, the court approved the transfer of property from one private party to another for the development of a privately owned and operated marina. According to the court, the city's goal of revitalizing a flagging local economy met the "public use" requirement. As in *Kelo*, the city had produced a comprehensive development plan prior to the challenged taking.

Some state courts have reached different results. In *County Com'rs of Muskogee Co. v. Lowery* (2006), the Oklahoma Supreme Court decided a condemnation case involving right-of-way easements for water pipelines that would service private electric generation plants. The court adamantly rejected the use of economic development alone as a means for a taking, and held that "the power of eminent domain should be exercised with restraint" and the term "public purpose" should be construed "narrowly." The court distinguished *Kelo* on the grounds that the Oklahoma condemnation statute did not specifically permit takings for economic development.

The District of Columbia Court of Appeals analyzed *Kelo*'s impact in *Franco v. National Capital Revitalization Corp.* (2007). Here, the District had condemned a private shopping center for what it contended were economic development purposes, in response to neighborhood pressure for a "big-box" retailer in a purportedly blighted area. The property owners contended that the "blight" finding was unsupported and that the stated rationale was pretextual. The court held that there are situations where a court should not accept the legislature's proffered rationale at face value, because a government rarely will acknowledge that it is acting for a forbidden reason. The court, therefore, held that a "pretextual" defense is legally sustainable in the District of Columbia, under the right circumstances. Pillsbury represented the largest property owner in the *Franco* cases.

Kelo's greatest and most rapid impact was not felt in the common law, but in the multiple state statutes passed in the wake of the decision.

This same defense, which has a sound basis in *Kelo*, has proven unsuccessful in the federal circuit courts thus far. In early 2008, the Second Circuit applied *Kelo* in *Goldstein v. Pataki*, which involved a well-publicized, multibillion-dollar development project in Brooklyn, New York. Although it would displace many homes and businesses, the project was touted as a catalyst toward the redevelopment of a blighted area in downtown Brooklyn. The project included a new sports arena for the New Jersey Nets, public open space, several office towers and at least 16 high-rise apartment buildings. The Second Circuit rejected the property owners' "pretextual" defense, holding that the mere fact that a private party stood to benefit enormously from the proposed taking was insufficient to suggest an improper "public purpose."

Post-*Kelo* Legislation

Probably *Kelo*'s greatest and most rapid impact was not felt in the common law, but in the multiple state statutes passed in the wake of the decision. By the end of 2007, 42 states had enacted some type of reform legislation in response to *Kelo*. These laws vary in scope; approximately half dramatically restrict the takings potentially allowed by *Kelo*, while other statutes place other, more modest limits on the power of municipalities to invoke eminent domain for economic development. Very few, if any, of these statutes have been tested yet in the courts.

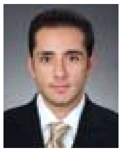
A typical example is California's Proposition 99 (2008), which generally prohibits state and local governments from using eminent domain to acquire a residence occupied by an owner for at least one year for "conveyance to a private person or business entity."

Future *Kelo* Impact

While *Kelo* was initially viewed as a likely catalyst for economic development, its effect was in many cases felt more in the legislative backlash. In addition to the immediate legislative reactions, in at least one instance, a city used *Kelo* to drive away, rather than attract, big business. In May 2006, the city council of Hercules, California, applying *Kelo* principles, voted unanimously to condemn 17 acres privately owned by Wal-Mart, the world's largest retailer. Hercules residents had spoken out overwhelmingly, complaining that big-box stores economically depress an area by driving small shops to bankruptcy and moving profits out of the local economy. Not surprisingly, the retailer currently is fighting back in court.

As of June 2008, Suzette Kelo's property was still a vacant lot, generating no tax revenue for New London. The state of takings jurisprudence post-*Kelo* stands, to some degree, in similar limbo. No clear theme emerges from the ensuing court decisions in answer to many of the questions left open in *Kelo*. One consistent thread, however, is clear from virtually all of the cases—the courts will defer to legislatures' stated intentions regarding the scope of eminent domain in their respective states if they wish to limit the ability of their local governments to take property. And the legislatures in most jurisdictions have indeed spoken out.

Deborah B. Baum
is a partner in Pillsbury's Washington, DC, office. She can be reached at 202.663.8772 or deborah.baum@pillsburylaw.com.



David Tabibian
is an associate in Pillsbury's Los Angeles office. He can be reached at 213.488.7392 or david.tabibian@pillsburylaw.com.

Construction Corner

Owners Should Be Careful Before Agreeing to Hire Engineers Directly

by Scott E. Barat and James P. Bobotek

The design of construction projects involves not only a lead architect but also structural, mechanical, electrical and other engineers. Although it is typical in commercial construction projects for the architect to retain these engineers as consultants, project owners often are tempted to retain them directly as part of a "design team" that reports to the owner. When asked whether this direct-hire arrangement is a good one to pursue, we walk our clients through the following list of advantages and disadvantages. Owners often conclude that the potential benefits of hiring the engineers directly do not outweigh the associated risks of doing so.

Possible Benefits

Loyalty to the Owner
When architects hire project engineers, the engineers may be torn between remaining loyal to their client (the architect) and executing the directives of the owner. In contrast, when the engineers' client is the owner, they are less likely to be distracted or biased by architect opinions that may conflict with the owner's prerogatives.

Cost Savings
Architects often impose a markup on the engineers' fees as compensation for managing the engineers and for taking the risk of the engineers' performance. By retaining the engineers directly, the owner may be able to save that markup. In addition, the owner may achieve some cost savings by conducting a separate competitive or negotiated procurement process for each engineer.

Better Control over Design
By contracting directly with each engineer, an owner may be in a better position to review the engineer's work, and ensure that the quality and type of system being designed is consistent with the owner's desires and/or pro forma as to initial price, functionality and operating costs.

More Rigorous Construction Administration
By having a closer relationship with each engineer, an owner may be in a better position to ensure direct participation of the engineers during the construction process, so that questions are answered and issues resolved as expeditiously as possible.

Likely Risks

Lack of a Single Point of Responsibility
In the traditional arrangement whereby the architect retains the engineers, the architect is responsible for the work of the engineers. Therefore, if there is a design issue, or a design error that leads to increased costs or delays, the owner need only look to the architect as a single point of accountability. If, however, the owner has retained the engineers, then the owner is the one who is responsible for each engineer. From the owner's perspective, sorting out liability for change orders will amount to a finger-pointing exercise—the contractor will claim drawing errors, the architect will blame the contractor and/or one or more engineers who work for the owner and for whom the architect is not responsible, and each engineer will blame the contractor and the architect or another engineer. Owners rarely want to take on this kind of responsibility or liability.

Lack of Coordination
Closely related to the absence of a single point of responsibility is the lack of coordination that may arise if the owner retains the engineers directly. One of the key functions the architect performs when he or she retains the engineers is to coordinate the work of those engineers, from both a scheduling and design perspective, and to foster a true team approach to the design that reflects the owner's program. If the owner retains the engineers, this schedule and design coordination become the owner's responsibility. Again, owners rarely want to assume the responsibility for coordinating the services of the architect and the several engineers.

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Greenwashing

by Warren U. Lehrenbaum and Christopher B. Leopold

As the issues of climate change and sustainability continue to gain prominence in the minds of the public, consumers are now demanding greater access to greener products and services. Not surprisingly, the increasing prevalence of green products has been accompanied by a high incidence of an advertising practice known as greenwashing. Greenwashing refers to the overstatement or misstatement of a product's environmentally friendly attributes. Examples of potential greenwashing in the real estate industry include overstatement of a building material's recycled material content, misrepresentation of a material's toxic qualities, or overgeneralization of a final product or building material's environmental attributes without proper substantiation (i.e., touting a product as green or eco-friendly without providing a rationale for the claim).

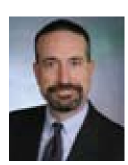
Although green advertising currently is not regulated *per se* by a federal agency, the Federal Trade Commission ("FTC") prosecutes actions for false and misleading advertising, which can include greenwashing claims. The FTC first issued guidance on green advertising in 1992, when it promulgated the Guides for the Use of Environmental Marketing Claims (Green Guides) to help companies determine whether or not their claims about a product's environmentally friendly attributes were acceptable under federal consumer protection laws. Although the Green Guides are not binding law, the FTC uses them as guidance to determine whether to prosecute environmental marketing claims as false or misleading under the Federal Trade Commission Act.

With the increasing prominence of green products, however, green advertising claims have changed significantly since this guidance was issued in 1992. The FTC currently is revising the Green Guides to address these developments. Through a series of public workshops and comment solicitations, the FTC has gathered input from a variety of different industries, including the real estate community. Key players from the real estate industry that have participated in this dialogue include the U.S. Green Building Council, the National Association of Home Builders, the Green Building Initiative, the Sustainable Forestry Initiative and the Vinyl Institute.

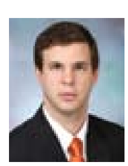
In August 2008, the FTC held a public workshop in Washington, DC, and solicited comments on the marketing of green building. Representatives of several large industry associations, including all of the organizations mentioned above, attended the workshop and provided comments reflecting their concerns on greenwashing and incorporation of green building into the Green Guides. A prime topic of discussion was that the current Green Guides do not provide any guidance specific to green building. The workshop participants, as well as the vast majority of public comments to date, have strongly supported the idea of incorporating guidance on green building marketing and advertising into the Green Guides. The consensus in the real estate and building products industries is that more transparency and standards in green building and related marketing efforts add legitimacy to the final product.

Additionally, the following issues have been prominent in the comment process thus far: (1) incorporation of third-party certification standards for green building into the Green Guides (such as LEED); (2) whether the process of third-party certification should be separated from the development of the certification standards; (3) incorporation of a life cycle analysis into certification standards (a life cycle analysis measures a product's environmental impacts for its entire life cycle, i.e., from raw materials extraction to ultimate disposal or reuse); (4) ensuring that certification standards are developed through a transparent process that includes public participation; and (5) whether to allow multiple certification standards in the Green Guides or to limit the number so consumers can compare products easily.

The FTC has not announced a date for the release of the revised Green Guides, but many observers expect the revised guides to be promulgated in 2009. Given the level of interest in green building, specific guidance on this topic almost certainly will be included in the revised Green Guides. We will continue to monitor the developments in this area and will provide analysis of the revised Green Guides upon their release.



Warren U. Lehrenbaum
is a partner in Pillsbury's Washington, DC, office. He can be reached at 202.663.8754 or warren.lehrenbaum@pillsburylaw.com.



Christopher B. Leopold
is an associate in Pillsbury's Washington, DC, office. He can be reached at 202.663.8054 or christopher.leopold@pillsburylaw.com.

CDARS—An Investment Safeguard Strategy

by Wendelin A. White, William C.F. Kurz and Soha Mody

The current uncertain economic environment and recent series of bank and investment firm failures have caused depositors to pay closer attention to where their funds are held. Real estate firms, in particular, are focusing on the safety of funds deposited in escrow, lockbox and other accounts, which frequently hold amounts far in excess of the present $250,000 FDIC insurance cap (which will return to the prior limit of $100,000 on December 31, 2009). CDARS accounts provide a simple, efficient way to obtain up to $50 million in FDIC protection on deposits.

CDARS—the Certificate of Deposit Account Registry Service—is a bank deposit placement service offered by Promontory Interfinancial Network that allows participating banks to place customer funds in uncertificated certificates of deposit in multiple other participating banks. The amount of the certificate of deposit issued by each bank, including both principal and interest earned, does not exceed the FDIC limit.

To start the process, the customer contacts a "relationship institution" (the bank into which the initial funds are deposited), and the parties enter into a CDARS Deposit Placement Agreement ("DPA") pursuant to which the relationship institution, as agent, places the customer's funds, through CDARS, with other "participating institutions." The relationship institution also enters into a custody agreement with The Bank of New York Mellon, pursuant to which The Bank of New York Mellon, as the subcustodian of the deposited funds, maintains a custody account in which the funds are held prior to investment in the certificates of deposit and again following redemption.

Each deposit-taking institution holds the funds in the name of "The Bank of New York Mellon, acting for itself and others, each acting for themselves and others." This account description allows the FDIC deposit insurance to "pass through" to the beneficial owner of the certificate of deposit. The Bank of New York Mellon's records reflect that each certificate of deposit is held by the relationship institution "acting for itself and others," and the relationship institution's records reflect the customer's holdings. No physical certificates evidencing the certificates of deposit are issued, which may be a concern for depositors who must take physical possession of a certificate. Also, care must be taken by a lender seeking to perfect a security interest in the customer's interest in such certificates of deposit. The customer, though not the direct holder of the certificates of deposit, is the beneficial owner, entitled to be paid the deposit and, if necessary, to claim FDIC insurance.

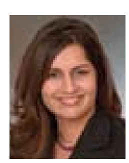
While the deposit and record-keeping structure within CDARS has some complexity, CDARS allows the customer to receive from its relationship institution a single monthly statement for all CDs acquired through CDARS. Thus, the customer holds FDIC-insured deposits but avoids the inconvenience of having to open accounts at multiple banks and to manage the separate CD terms, interest calculations, monthly statements, 1099 statements and banking relationships. CDARS consolidates these functions, while giving the customer the flexibility to determine the term of deposit and rate of interest acceptable for each CDARS placement under DPA (although interest rates earned on CDARS placements may be lower than on more aggressive, "jumbo" certificates of deposit). The customer also is able to designate particular participating institutions for exclusion from the list of banks eligible to hold its funds. This right is typically exercised to ensure that a bank where the customer already has funds on deposit does not receive additional funds that would exceed, in the aggregate with existing deposits, the FDIC limit. No fees are charged to the customer for placement of funds through CDARS.

The advantages of CDARS placements are several. They provide the customer with increased safety for deposits that would otherwise exceed the FDIC limit by breaking them into smaller amounts placed in multiple participating banks. CDARS also allows the customer to maintain a single banking relationship and significant control over the disposition of its funds. The CDARS program is offered in all 50 states and the District of Columbia, typically through regional and local banks.

Note: CDARS is a registered service mark of Promontory Interfinancial Network, LLC. The Bank of New York Mellon is a client of Pillsbury, and one of the Bank's affiliates is an investor in Promontory Interfinancial Network, LLC.

Wendelin A. White
is a partner in Pillsbury's Washington, DC, office. She can be reached at 202.663.8360 or wendelin.white@pillsburylaw.com.

William C.F. Kurz
is a partner in Pillsbury's New York office. He can be reached at 212.858.1242 or william.kurz@pillsburylaw.com.



Soha Mody
is a senior associate in Pillsbury's Washington, DC, office. She can be reached at 202.663.8099 or soha.mody@pillsburylaw.com.

The Cost to Borrowers of Buying Time in a Loan Workout or Restructuring

by Mark D. Graham

While discussions of real estate loan restructurings and workouts frequently revolve around protecting the interests of the lender, a borrower has its own interests to look after. A borrower will focus primarily on delaying the lender's enforcement of its remedies. However, buying this additional time can be very costly. A borrower and its attorney must weigh carefully the effects on a borrower of giving up certain rights and protections while trying to reach an agreement with a lender to restructure a troubled loan.

A borrower with a loan in or near default considers itself in a desperate situation. The borrower is anxious to avoid the onset of an "event of default" or, if such a default has already occurred, and the borrower's notice and cure rights have lapsed, to keep the lender from exercising its available remedies. Discussions with the lender to modify the loan payment terms often ensue, with the borrower's goal being to get the lender to forbear from exercising its rights and remedies so long as the borrower complies with the revised loan terms.

Lenders generally prefer receiving loan payments (even if those payments need to be restructured) to the time and expense associated with foreclosing on properties (and subsequently operating, marketing and selling those properties). Even so, defaulting borrowers soon realize that lenders intend to extract concessions as a condition to loan modifications and forbearance. These concessions often are designed to ensure that the lender's liens are not adversely affected and to streamline the enforcement of the lender's remedies if the proposed restructuring ultimately fails.

Concessions demanded may include:

- Acknowledgment of the amount of the indebtedness and of the default
- Waiver of defenses and claims or counterclaims against the lender
- Waiver of notice and grace periods, and immediate acceleration of the indebtedness upon a default under the restructured loan
- Execution and delivery in escrow to the lender of a deed in lieu of foreclosure (for filing upon a future stated default)
- Consent to entry of a foreclosure judgment (upon commencement of a foreclosure action by the lender upon a future stated default)
- Converting obligations of a borrower or a guarantor from non-recourse to recourse obligations
- Consent to lifting of the automatic stay in the event of the borrower's bankruptcy

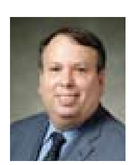
While a borrower may believe it has no choice but to accept these terms from the lender, the effect of losing these rights must be weighed carefully and defenses to the lender's actions considered. For example, if the alleged default is a payment default, there may be a dispute about the lender's calculation of the interest rate or of the amounts due. If the loan is a project development loan, perhaps the lender did not advance the funds in such amounts and at such times as set forth in the loan documents. Finally, though lender liability claims are often unsuccessful, the lender's behavior in the specific situation could have been sufficiently culpable that it would be prepared to be more flexible in negotiations.

In addition, a borrower must make a realistic assessment of whether it can comply with the revised loan terms. Hard questions include:

- Is the default the result of a temporary situation (e.g., a short-term construction delay or labor problem) or a long-term problem?
- Is there sufficient cash flow to meet the restructured payment terms?
- Is a quick sale of the property or a refinancing a realistic alternative if the restructuring fails?

A default under a restructured loan likely will leave the borrower in a much weaker position than upon the initial default. Depending on the terms of the forbearance agreement and the enforceability of some of the lender's remedies, (i) the lender will have easier and faster means to take the property, (ii) the borrower (and guarantor) may now have liabilities that initially were non-recourse, and (iii) the borrower's defenses and claims against the lender will be lost, and perhaps some of the borrower's rights in bankruptcy may be compromised.

While loan restructurings and workouts can help buy time, a borrower and its attorney must consider carefully whether the price is worth paying.



Mark D. Graham
is counsel in Pillsbury's New York office. He can be reached at 212.858.1176 or mark.graham@pillsburylaw.com.

California's Foreclosure Reform Law

Homeowners and Tenants Gain Protections

by Angela M. Yates and Diane Bazan Young

In July, the California State Legislature enacted legislation protective of defaulting homeowners and tenants of homes in foreclosure, adding new requirements for foreclosing lenders to address the adverse effects of the state's high foreclosure rate. The new law ("SB 1137") requires lenders to contact homeowner borrowers to explore options for avoiding foreclosure on their primary residence at least 30 days before filing a notice of default ("NOD"), gives tenants in possession of a rental housing unit at the time the property is sold in foreclosure 60 days' notice to vacate the property, and requires owners acquiring vacant residential real property through foreclosure to maintain the exterior of those properties. The new law took effect in July and remains in effect until January 1, 2013.

Conditions to Filing a Notice of Default

SB 1137 prevents a lender from filing an NOD pursuant to Section 2924 of the California Civil Code ("Section 2924") until 30 days after the lender has made contact with the borrower in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure.

In order to satisfy its obligation to contact the borrower, the lender must perform specific, sequential tasks, outlined by SB 1137, until the borrower is actually reached, all methods of contact have been exhausted, the borrower has surrendered the property, the borrower is in an active bankruptcy, or the borrower has contracted with a person or entity whose primary business is advising people on how to extend the foreclosure process or avoid their contractual obligations to mortgage lenders.

An NOD must include a declaration from the lender that it has either successfully contacted the borrower, that it has exercised the due diligence required by the statute to make contact with the borrower, but has failed to do so, or that the borrower has surrendered the property to the lender. This provision applies to all types of loans made to borrowers between January 1, 2003, and December 31, 2007, that are secured by the principal residence of the borrowers, regardless of the nature or purpose of the loan.

Notices to Residential Tenants

SB 1137 requires that, upon posting a notice of sale on the property to be sold pursuant to Section 2924, a specific notice addressed to the residential tenants also must be posted on the property and mailed to the resident of the property subject to the foreclosure sale. The required text of such notice is included in SB 1137 and must be translated into English, Spanish, Chinese, Tagalog, Vietnamese and Korean. This provision applies to loans secured by residential real property if the billing address for the mortgage note is different than the property address.

SB 1137 also provides that a tenant or subtenant in possession of a rental housing unit at the time the property is sold in foreclosure must be given 60 days' written notice to vacate the property before such tenant or subtenant may be removed from the property.

Maintenance Obligations for Properties Acquired through Foreclosure

SB 1137 also requires the legal owner to maintain the exterior of vacant residential property purchased by that owner through foreclosure in good condition or be subject to a fine of up to $1,000 per day. If the governmental entity chooses to impose a fine, it must give notice of the alleged violation and pending fine, and the fine may be assessed if action to correct the violation is not commenced within a period of not less than 14 days and completed within a period of not less than 30 days.

In sum, the protections to homeowners and tenants afforded by SB 1137 come at the cost of several additional requirements that lenders must satisfy before the conclusion of the foreclosure process. Although the California Legislature is certainly hopeful, the impact of such requirements on California's increasing foreclosure rate remains to be seen.

Angela M. Yates
is a partner in Pillsbury's San Diego office. She can be reached at 619.544.3217 or angela.yates@pillsburylaw.com.

Diane Bazan Young
is a senior associate in Pillsbury's San Diego office. She can be reached at 619.544.3118 or diane.young@pillsburylaw.com.

Strategies for Real Estate Outsourcing

by John L. Barton and Roger C. Roy, Jr.

Most companies with sizable real estate portfolios obtain facilities management, project management, lease administration and transaction management services from a variety of service providers across the real estate, construction and maintenance industries. In many cases, however, these companies, whose core mission is not real estate, have simply "out-tasked" individual functions and facilities on a piecemeal basis, and now find themselves with overlapping internal and external relationships, flat or increasing costs, little integration or consistency across functions and facilities, and limited access to meaningful performance data. A clear sourcing strategy can solve most if not all of these issues.

The real estate outsourcing market has matured significantly in recent years, such that service providers are now able to address these problems with cross-functional staffing, integrated IT systems, standardized delivery processes, networks of subject matter experts and sourcing capabilities that leverage billions of dollars in purchasing power. As a result, many companies are considering outsourcing real estate services for the first time or restructuring existing outsourcing relationships as a means to transform their real estate operations, generate cost savings and take advantage of new options in the marketplace.

Across multiple industries, we have found companies that take advantage of these new options realize significant near-term and long-term operational savings at the same or better performance level. There are, however, a number of challenges customers must address in structuring a sourcing strategy.

Baseline Data

Providing potential service providers with accurate and detailed data about the facilities to be outsourced early in the evaluation process is essential (i.e., information about current facilities' management costs, personnel, third-party service providers, technology, square footage and other building attributes). With this data, service providers are able to propose detailed staffing models, site-level budgets, cost-reduction commitments and custom solutions in their proposals. Without it, customers are more likely to receive proposals with generic descriptions of service provider capabilities and "time and materials" or "per square foot" rates (but no budgets or cost-reduction commitments), all qualified by many assumptions to be validated after contract execution.

Pricing Structure

Real estate outsourcing deals are frequently priced on an open-book basis, which allows for meaningful risk/reward pricing structures. These structures better align customer and service provider incentives, and include linking pricing metrics with the volume of service required rather than the resources required to provide those services (e.g., per square foot or lease rates rather than cost-plus margin structures), as well as establishing clear budgeting and sourcing controls, requiring service providers to place significant portions of their fees at risk for achieving savings commitments, and providing financial incentives for service providers to innovate and continually implement new savings initiatives.

Global Relationships

Agreements should be structured in a manner that allows the customer to obtain services anywhere in which he or she operate, without the need to renegotiate pricing, tax, liability, or other legal or commercial terms. Addressing these issues up front and including form country-enabling agreements and other appropriate documentation in the master agreement should allow customers to move quickly when their business requires new space, project managers and facilities management support in a new market.

Human Resource Considerations

Real estate outsourcing initiatives often involve the transfer of employees from the customer (or the customer's incumbent provider) to a new service provider. It is essential to identify legal requirements, and define a clear strategy and communication plan early in the process to address HR issues. This is particularly true in Europe, where HR laws and regulations can significantly impact the customer's business case and schedule.

Through careful drafting and a focus on proper risk allocation across all legal and commercial terms, the customer can shift many of the legal, performance and financial risks to the service provider.

Risk Transfer

In addition to improving service and reducing cost, real estate outsourcing enables customers to shift some of the risks of service delivery to a service provider. A common contract structure often proposed by service providers allows the service provider to contract with subcontractors as the customer's agent, pass through all costs of service delivery and apply a negotiated markup on all costs as compensation. High-level Key Performance Indicators ("KPI") may exist, but they often measure the wrong data points and have relatively small financial consequences attached to them. This structure exposes the customer to significant legal risk and virtually guarantees that the service provider will make a good profit, regardless of how well it performs.

Through careful drafting and a focus on proper risk allocation across all legal and commercial terms, the customer can shift many of the legal, performance and financial risks to the service provider.

Change Management

The extent of "change management" required to source certain real estate functions is often underestimated and can result in relationship challenges between the service provider and end users. This is often the case when employees and profit and loss responsibility for functions or facilities to be outsourced are dispersed among multiple functional groups and business units. By attaining, at an early state, executive commitment to the overall program and the transformation activities required for the program to be successful, this pitfall can be avoided.

Preserving Leverage

Given the dynamic nature of most real estate environments, customers will need to negotiate new services, budgets, performance levels and other changes frequently with their service providers. In addition to defining the proper governance structure and maintaining a good working relationship with the service providers, customers need an agreement that provides them with substantial negotiating leverage. Following are some of the ways this can be accomplished:

Non-Exclusivity

Sourcing agreements should not be exclusive. Customers should always preserve the right to withdraw scope and transition services back in-house or to a third party. Pricing methodologies should accommodate this structure.

Termination Rights

Customers should have the right to terminate the agreement at any time for convenience, in some cases for a negotiated termination fee. Service providers should not have the right to suspend or terminate services for any reason other than a customer's failure to pay substantial undisputed charges.

KPI Credits

Service providers should be required to place a substantial portion of their overall fees at risk for failure to meet KPIs. When KPI failures occur, customers have the option of collecting large credits or exchanging them for service enhancements or other concessions from the service provider.

Disengagement Assistance

Customers must preserve a credible threat to transition services back in-house or to a third party. In addition to termination and scope of withdrawal rights, a customer should maintain ownership of equipment and software, preserve the right to hire service provider personnel and assume existing third-party service contracts upon expiration or termination of the agreement.

Renewal Rights

Customers often may negotiate unilateral rights to renew their agreements under existing terms and pricing. This allows them to enter into negotiations after the initial term without the threat of substantial pricing increases or service disruption if the parties are unable to reach agreement on new terms.

As the economy tightens, companies whose core mission is not real estate development, ownership or management should consider outsourcing real estate functions or consolidating existing outsourcing relationships under an integrated technology platform and solution. When undertaken systematically and with a clear sourcing strategy, doing so may lead to significant cost savings and operational efficiency.

John L. Barton
is counsel (partner effective January 2009) in Pillsbury's Washington, DC, office. He can be reached at 202.663.8703 or john.barton@pillsburylaw.com.

Roger C. Roy, Jr.
is a consulting principal in Pillsbury's San Francisco office. He can be reached at 415.983.1044 or roger.roy@pillsburylaw.com.

Construction Corner

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Increased Administrative Burden
If the owner takes on the responsibility for coordinating each party's obligations, the owner will need the manpower and expertise to do so. Drilling down into the minutiae of the design and the related contracts may distract the owner's personnel from tasks they are better trained to deal with and find more interesting.

Likely Conflicting Contract Terms
If the owner enters into separate contracts with the architect and the engineers, there likely will be differences in the terms of those contracts, depending on how negotiations proceed and the relative bargaining strength of the parties. Trying to get all of the design contracts to work together not only will be an administrative burden, but the allocation of risk in those contracts may be inconsistent and may make resolving issues more difficult than if the owner had only one contract with the architect.

Increased Likelihood of Onerous Contract Terms in the Architect Agreement
On one hand, the architect may be pleased if the owner retains the engineers because the architect will be relieved of the liability for the work of those engineers. However, the savvy architect will insist on an onerous exculpation provision in its agreement with the owner stating that the architect has no coordination responsibility and providing that the owner must indemnify the architect for claims resulting from the work of the separate engineers.

After evaluating the above considerations, we expect that most owners will continue to rely on architects to hire and coordinate the efforts of project engineers.

Scott E. Barat
is a partner in Pillsbury's Northern Virginia office. He can be reached at 703.770.7995 or scott.barat@pillsburylaw.com.

James P. Bobotek
is a senior associate in Pillsbury's Northern Virginia office. He can be reached at 703.770.7930 or james.bobotek@pillsburylaw.com.

Editorial Staff

Editor-in-Chief
Laura Hannusch

Editors
Pete Freeman
Jon Goetz
Michael Silver

Production
Amanda Acevedo
Sara Cohen

For mailing list inquiries, email real.estate@pillsburylaw.com.

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