PILLSBURY WINTHROP LLP

on real estate

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a newsletter for the real estate industry







PUBLIC/PRIVATE PARTNERING: BOEING'S PACIFICENTER @ LONG BEACH

Since William Edward Boeing first opened the doors to his airplane manufacturing company in 1916, The Boeing Company has remained at the top of America's highly competitive aeronautics industry through a combination of savvy business planning, efficient management, and the ability to creatively adapt to the changing economic environment.

by Lew Feldman

Last year, Boeing Realty Corporation continued that tradition when it proposed a public/private partnership with the City of Long Beach to provide a state-of-the-art, mixed-use, master-planned development to be known as "PacifiCenter @ Long Beach." The project is to be located on approximately 233 acres of The Boeing Company's aircraft manufacturing plant located in Long Beach, California.

According to Phil Cyburt, President of Boeing Realty Corporation, "CEOs of today's innovative companies are looking for a community that provides a vibrant live-work-play environment." To meet that demand, PacifiCenter @ Long Beach will feature approximately five million square feet of office, flex-tech and light industrial space, supported by an advanced technology infrastructure, two hotels, and 150,000 square feet of shops, restaurants and other amenities, plus more than 2,500 multifamily residential units, including townhomes, condominiums, apartments and lofts. PacifiCenter @ Long Beach will also include an educational resource center devoted primarily to technological research that will be available to and managed by a consortium of Southern California's finest local colleges and universities.

Public Benefits. Michael Russell, Senior Vice President of PacifiCenter @ Long Beach, holds high hopes for the public/private venture. "The entire community," says Russell, "stands to benefit from the new opportunities that we will bring." Russell notes that PacifiCenter @ Long Beach is in the very early stages of the development process and construction of the first phase is not expected to commence for another 24 months. Boeing Realty Corporation is committed, however, to working closely with the City of Long Beach throughout the course of the development. "We are going to work with the City on whatever it takes to follow their guidelines and processes," says Russell, "so that we can create not only a great plan, but also a very positive process from all of our efforts."

(*Boeing* continued on page 4)

by Mary B. Cranston

From the Chair

I am pleased to announce the publication of the premiere edition of *Pillsbury Winthrop LLP On Real Estate*. This newsletter was prepared by our Global Real Estate, Project Development and Construction Practice Section. With over 100 attorneys practicing real estate law, Pillsbury Winthrop's real estate practice includes the representation of developers, investors, lenders, landlords, tenants, contractors and the like, in a variety of finance, development, acquisition, leasing and investment transactions involving the public and private sectors.

Many of our real estate lawyers are based in our Century City, Los Angeles, Orange County and San Diego offices. It is therefore appropriate that this first edition of our real estate newsletter consists of articles written by our Southern California attorneys.

Our real estate practice, like all other practice areas at Pillsbury Winthrop, is guided by the core principles of Superior Service, Committed People, Clear Direction, Excellent Information and Pride in Achievement. Through the consistent application of these principles, our firm's real estate practice is one of the highest quality, cutting-edge practices offered globally.

The articles in this newsletter are intended to demonstrate one of the ways in which we implement our guiding principles. In writing on legal issues of current interest, we hope to provide you with an introduction to the services we offer, and a glimpse at our clients and their remarkable successes.

On behalf of the attorneys, paralegals and staff at Pillsbury Winthrop LLP, we wish each of you a healthy and happy holiday season!

GOING PRIVATE FOR THE PUBLIC GOOD

by Tuan Pham

In August of this year, Pacific Gulf Properties Inc., a publicly-traded real estate investment trust (NYSE: PAG), liquidated its $900 million industrial portfolio and its $150 million multi-family apartment portfolio, and merged its senior apartments portfolio into privately-held FountainGlen Properties, LLC. To the public, Pacific Gulf Properties was a billion-dollar plus real estate investment trust with proven performance, gifted management, strong financials, and solid growth. By all appearances, continued success was assured. So why did a profitable public real estate company go private? To paraphrase the famous adage: why fix something when it's not broken?

For the former senior executives of Pacific Gulf Properties (who became investors in, and serve as the management of, FountainGlen), the answer was simple: *make it better* - not only for the company itself, but for the company's shareholders and stakeholders.

Heading FountainGlen as President and Chief Executive Officer is Glenn L. Carpenter, a veteran real estate professional with 35 years of experience. FountainGlen's Operations Officer is Kimberly Solbakk. Angela Wixted serves as Chief Financial Officer and Curt Miller is the Senior Vice President of Construction and Development. All four executives served in the same or similar capacities for Pacific Gulf Properties.

The liquidation and merger of Pacific Gulf Properties into FountainGlen was immediately evident to the shareholders of Pacific Gulf Properties. The decision to merge Pacific Gulf Properties' senior apartments portfolio and to liquidate all of its other assets was fortuitously timed to maximize benefit to shareholders. "We had an opportunity to do something very special for shareholders, and we seized it," said Mr. Carpenter.

> *"We had an opportunity to do something very special for shareholders, and we seized it."*
>
> Glenn Carpenter, Chief Executive Officer and President of FountainGlen Properties, LLC

The "opportunity" alluded to by Mr. Carpenter was the ability to sell Pacific Gulf Properties' industrial property and multifamily portfolio during a strong real estate market. Although Pacific Gulf Properties was a well-respected company, it - along with many other REITs - was undervalued by the securities market. At the time of the liquidation and merger, shares of Pacific Gulf Properties were traded at approximately $21 per share. However, upon liquidation and merger, shareholders realized a value of over $28 per share. Management's decision to go private translated into nearly 35% profit for shareholders.

To the real estate community, the merger represented the emergence of FountainGlen as a leader in the development of apartment communities tailored specifically for the growing population of active seniors. Until recently, the apartment industry largely overlooked the active senior community, viewing senior housing as either congregate care or assisted living. By default, the housing inventory available to active seniors consisted primarily of traditional apartment living. Traditional apartment living failed to meet the needs of active seniors, such as social, educational, fitness and longevity activities, layouts and floorplans tailored to overnight visits by grandchildren, community gatherings, and the transportation needs of mature adults. The gap between the supply of, and demand for, active senior housing continued to grow.

The merger of Pacific Gulf Properties into FountainGlen signals the closing of the gap. "The search for an apartment for my grandfather to live in that responded to his active lifestyle needs clearly opened my eyes to the severe shortage of quality housing alternatives available for this deserving, underserved and growing segment of our population," said Mr. Carpenter. "FountainGlen's primary mission is to develop quality apartment communities for active seniors in California and the Western United States and focus all of its energies, efforts and financial strength on being a leader in meeting the needs of this exciting and deserving demographic segment."

The upshot of FountainGlen's focus has been significant. FountainGlen's portfolio already consists of twelve active senior properties, eight of which are fully operational. The remaining four properties are in varying stages of construction or development, and still more developments are forthcoming. All of FountainGlen's properties are designed to fit the lifestyles of its active senior base, and feature three-story apartment buildings with spacious clubhouses, fitness centers, pools, spas, libraries, computer learning facilities, courtyards and extensively scheduled social activities. Typical rental rates, depending on a given market, range from approximately $700 to $1,200 per month. The average age of a FountainGlen resident is 71.

Mr. Carpenter recognized that the lack of active senior housing meant that such product had to be created, which meant that capital was required. Obtaining capital from the public capital markets through stock issuances would be inefficient because the market would not give full value to investments of this nature.

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LIABILITY ISSUES FOR LANDLORDS

by Henry Stiepel

and Daniel Cho

The degree to which an owner and property manager of a multi-tenant project may have liability to tenants has been the subject of judicial scrutiny over the last few decades.

The acts of criminals and terrorists causing property damage and personal injury give rise to potential liability of an owner and may create a duty of the owner to protect tenants and visitors.

Generally, in assessing a landlord's potential liability toward a tenant or a visitor for the criminal acts of a third party, absent a contractual provision to the contrary, courts will look to standard principles of negligence. Did the landlord have a duty toward the injured person? Was that duty breached? If so, did the breach "proximately" cause the injury?

The initial and most critical issue in this analysis is whether, under a given set of facts, the landlord had any duty toward the victim of the crime. In making that determination, courts look to the foreseeability of the particular criminal act, i.e., whether the landlord should have reasonably expected that such a crime could have occurred on its premises. In doing so, courts will balance the foreseeability of the harm against the burden imposed. In *Ann M. v. Pacific Plaza Shopping Center*, 6 Cal. 4th 666, 674 (1993), the court summarized this principle by stating that a landlord's duty is to "take reasonable steps to secure common areas against foreseeable criminal acts of third parties that are likely to occur in the absence of such precautionary measures." In the *Ann M.* case, the plaintiff was the victim of a sexual assault that took place within a shopping center. However, because the shopping center had no previous history of similar incidents of violent crime or other indications of a reasonably foreseeable risk of violent criminal assaults, the court held that the owner had no duty to the plaintiff to provide security patrols in the common areas of the shopping center.

Similar to the criminal acts of third parties, courts will also apply the foreseeability analysis with respect to the dangerous propensities of existing tenants in determining whether a landlord had a duty toward a victim

(*Liability* continued on page 5)

9-11: THE INSURANCE AFTERMATH

by Michael Meyer

and John Duffy

The skyline of New York City is not the only thing that will look much different following the destruction of the World Trade Center from the September 11 terrorist attacks. Not surprisingly, the insurance landscape has also been dramatically altered. To adjust to the new reality of living with terrorism, the insurance industry will redefine the risks to be covered by future policies. The adjustments made by the insurance industry will have a tremendous effect on how landlords and tenants structure leases and provide for insurance.

Before discussing some of the lease provisions that will be affected by the events of September 11, it should be noted that the property damage to the World Trade Center will almost certainly be covered by insurance. In general, on and prior to September 11, the property damage coverage that was carried by almost all major landlords in the United States would cover the damage or destruction of a building caused by a terrorist act. Prior to September 11, damage or destruction by a terrorist act was treated the same as damage or destruction by an ordinary fire. These policies would also provide for net rent continuation proceeds for approximately one year.

Typically, the property insurance policy that covers a high-rise office building is referred to as an "all-risk" policy. The all-risk policy insures against the loss of, or physical damage to, property arising from any perils that are not specifically excluded. Covered perils generally include those caused by a fire, wind storm, hail, explosion, riot, riot attending a strike, impact of aircraft and vehicles, and smoke damage. Generally excluded from coverage under an all-risk policy is damage resulting from "acts of war." However, the current consensus is that this exclusion does not apply to terrorist acts and, so far, it does not appear that any insurance carrier is taking a contrary position with respect to the events of September 11. If an insurance carrier were to take a contrary position, in an all-risk policy the burden of proof that a peril causing the loss was excluded is borne by the insurer.

In the aftermath of September 11, however,

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LEASE SECURITY IN AN UNCERTAIN ECONOMY

by Eric Kremer

Building owners are used to experiencing adverse business conditions. In addition to weathering the general economic down-cycles, landlords have faced failed savings and loan institutions and periods of hyper-inflation.

Unfortunately, the spectacular failings of many "dot-coms" in recent years have posed additional challenges to building owners and highlighted many of the limitations in typical leases. Consequently, many landlords are re-examining their leases, in particular security deposit and sublease provisions. And now, with the business climate turning from red-hot to icy-cold, what lessons have landlords learned in their efforts to protect themselves from failing tenants?

Security Deposits. Landlords often try to protect themselves from tenant defaults by taking security deposits. Most commonly, the security deposits are in the form of cash. But, landlords have increasingly required letters of credit securing rent and tenant improvement investment in their buildings. Less traditionally, some landlords have taken security in the form of equity in their tenants. Whatever their form, security deposits in some circumstances will not provide the protection desired by landlords.

Cash. Although cash is generally king in most businesses, the large number of dot-com bankruptcies reminded landlords that bankruptcy courts may construe cash security deposits held by landlords as bankruptcy estate assets subject to recapture in accordance with bankruptcy law. Moreover, a lease itself may become an asset of the bankruptcy estate, subject to acceptance or rejection by the bankruptcy trustee. Generally, if the trustee elects to continue a lease (based on some expectation of reorganization), the bankrupt tenant must cure defaults under the lease as a condition to continuing the lease. However, if the trustee rejects the lease, the bankruptcy code prescribes certain formulas for the calculation of rental due to landlords, which often limits recovery of delinquent rent. The challenge for landlords is to fully understand the reach of the bankruptcy courts with respect to cash deposits.

Letter of Credit. A letter of credit has often been used as an alternative to cash. A letter of credit offers a number of attractive benefits to landlords. It is generally not regarded as an asset of a bankrupt tenant's estate because of the independence principle of the letter of credit obligation. Technically, a draw on a letter of credit is a draw on the issuing bank's assets rather than the tenant's. Unlike cash, in a bankruptcy by a tenant, landlords may have full recourse against the entirety of the letter of credit amount.

A letter of credit, however, does have its limitations. Although draws on a letter of credit may cover rental obligations for the periods of time during which landlords are involved in tenants' bankruptcies, a letter of credit may not cover rent for the full periods of time necessary for landlords to secure new tenants after vacation of the spaces by the defaulting tenants. It should also be noted that amounts drawn on a letter of credit are typically not described in leases as liquidated damages covering all damages incurred by landlords in connection with defaults under the lease. Thus, what may seem to be a windfall to landlords does, in fact, need to bear a relationship to the actual damages suffered by landlords as a result of the failure to pay rent, termination of the lease and reletting of the premises. Finally, in structuring a letter of credit, some tenants may require that draws may only be made in the amounts of the claimed defaults, i.e., landlords may only draw the amount of each installment of monthly rent as it becomes due even though the tenant has defaulted and has abandoned the premises.

Equity. Some landlords took stock warrants or securities in their tenants in connection with their leases. Most landlords have realized the fallacy of taking equity as a hedge against default since an equity position does not offer any protection for landlords in the event of tenants' financial downturns. Instead, landlords have grown to view an equity stake as conferring a potential upside gain in the event their tenants are wildly successful in their operations.

The dot-com meltdown, however, reminded landlords that there is no such thing as a free lunch. Even if the tenant is successful, the structure of the securities themselves, and the rights attached to the securities, can pose problems to landlords in realizing on their

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The benefits of those efforts are expected to include approximately 24,000 high-quality new jobs, a variety of new restaurants, outdoor cafes and shops, a significant increase in scarce affordable housing units, new recreational amenities, street improvements, a transportation management program that will relieve current traffic congestion, and a vital educational resource. All tolled, Russell expects the project's economic benefit to the community to exceed $2 billion annually.

Public/Private Partnerships. Like Boeing Realty Corporation and the City of Long Beach, responsible businesses and forward-thinking municipalities are increasingly joining forces in so-called "public/private partnerships" to facilitate the financing and construction of public infrastructure for important economic and community amenities. These joint ventures provide an extremely efficient financing and development vehicle, and enable both parties to share the "three R's" of land development - risk, responsibility and reward. In the most successful of these partnerships, the public agency benefits from the efficiency and expertise of a private sector builder and the ability to finance its public improvements "off-book," while still maintaining a controlling hand in the planning and implementation of the facilities. In exchange, the developer often enjoys a more effective entitlement process, and the opportunity to work hand-in-hand with the community.

"The entire community stands to benefit from the new opportunities that we will bring." — Michael Russell, Senior Vice President of PacifiCenter @ Long Beach

The PacifiCenter @ Long Beach Model. Boeing Realty Corporation tapped Pillsbury Winthrop LLP's Structured Finance Group to help structure and implement the complex financing that will be used to construct PacifiCenter @ Long Beach. After analyzing Boeing Realty Corporation's plans and objectives, Pillsbury Winthrop recommended a sophisticated financing plan built upon the following major components:

- The execution of a development agreement for the project with the City of Long Beach specifying the duties and obligations of each party in connection with the financing, development and maintenance of required infrastructure.
- The formation of a community facilities district and the issuance by that district of bonds secured by special taxes to be levied on district property, with the proceeds from the sale of the bonds to be used to finance the acquisition and construction of the requisite infrastructure for PacifiCenter @ Long Beach.
- The issuance of housing revenue bonds to finance the construction of single-family and multifamily housing, with the housing bonds to be structured, where possible, to take advantage of available federal tax credits and/or California property tax abatements.

This three-pronged financing approach will serve several key public and private objectives.

Development Certainty. Under California law, cities and developers may enter into agreements that effectively protect specific developments from future changes in land use laws and regulations. The PacifiCenter @ Long Beach development agreement would assure the applicability of existing land use regulations and entitlements throughout the development process, while still providing flexibility to address the dynamics of the market.

Sound Financing of Public Infrastructure. The Mello-Roos Community Facilities Act of 1982 provides California public agencies with an effective financing vehicle for funding public infrastructure improvements. The formation of a Mello-Roos community facilities district requires the approval of the registered voters within the proposed district boundaries (or the district landowners, if there are fewer than 12 registered voters). Once formed, the district may levy a special tax on the land within the district and issue tax-exempt bonds secured by that tax to finance the required improvements. By placing PacifiCenter @ Long Beach within a community facilities district, a variety of public improvements may be financed with the proceeds of tax-exempt bonds, including roadways, water facilities, schools, police and fire stations, parks, and libraries. The maintenance of these public facilities as community amenities may also be ensured.

Multifamily Revenue Bonds. Public agencies may issue tax-exempt multifamily revenue bonds to help developers construct new affordable apartment projects or purchase and rehabilitate existing units. The bonds are payable from the revenues of the housing project. Housing bonds will provide to developers within PacifiCenter @ Long Beach less expensive, tax-exempt financing in exchange for the developer's promise to set aside a portion of the rental units for income-challenged households and, in some cases, to restrict the amount of rent that such households may be charged.

A Good Neighbor. During World War II, the manufacturing facility that was located on and around the PacifiCenter @ Long Beach site employed some 50,000 workers and produced one airplane every two hours. In 1958, the facility produced the McDonnell Douglas Corporation's first DC-8, which took its maiden flight over the Long Beach area. In 1997, McDonnell Douglas merged with The Boeing Company. The Boeing Company still produces the successful 717 and C17 aircrafts at its Long Beach facility.

Throughout its history, The Boeing Company and its predecessors have remained committed to the Long Beach area, continually striving to contribute to the communities that have supported their success. In that spirit, PacifiCenter @ Long Beach has been designed with great care to complement and enhance the surrounding community. Pillsbury Winthrop is proud to play a small part in helping The Boeing Company continue its legacy as a responsible corporate citizen and good neighbor.

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"In the Co
Firefighter Angel Making

At an October 9, 2001 press conference, Los Angeles Mayor James Hahn announced that a very special sculpture would make its way to a new home in New York City. That sculpture - the Firefighter Guardian Angel - was designed by artist Janine Anderson and previously graced the lobby of Pillsbury Winthrop LLP's Downtown Los Angeles office. Michael Meyer of the firm's Downtown Los Angeles office contacted the Mayor's office to donate the Firefighter Guardian Angel to the City of Los Angeles and its Fire Department so they, in turn, could present the work of art to the people of New York, following the tragedies of September 11. "We have a long standing respect and admiration for the Los Angeles firefighters and law enforcement and we wanted to give something back to this community. If this angel can serve even the smallest role in lifting spirits in New York, that would be a double honor," said Meyer.

The Firefighter Guardian Angel was created through a public art project initiated by the Volunteers of America and Catholic Big Brothers to raise funds to support youth programs. Pillsbury Winthrop supported the charity by acquiring the angel last spring.

The donation reinforces the relationship that Pillsbury Winthrop has with New York City and its citizens. Pillsbury Winthrop's New York office is less than ten blocks from the World Trade Center. In the first week following the terrorist attacks, the New York office was required to be closed along with other business in the area adjacent to ground zero. The Judge Advocate General Section of the 42 Aviation Brigade set up temporary headquarters in Pillsbury Winthrop's conference rooms while troops of the National Guard camped across the street.

mmunity"
Transcontinental Flight

When the Firefighter Guardian Angel was donated, Marina Park, Pillsbury Winthrop's Managing Partner, said, "This is a small token for the sacrifice and tremendous work that the men and women in New York's fire and law enforcement have given these past several weeks."

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harmed by the actions of an existing tenant. The mere fact that an existing tenant engages in a dangerous activity is typically not sufficient to impose liability upon a landlord, nor is a landlord ordinarily imputed a duty to monitor the unusual or erratic behavior of its tenants. Rather, courts have required victims to show that the landlord knew, or should have known, that the tenant's activity at the premises created a potential for foreseeable harm to others and that the landlord could have taken reasonable steps to prevent such harm. See *Davis v. Gomez*, 207 Cal. App. 3d 1401 (1989).

In the *Davis* case, an apartment building tenant was fatally shot by another tenant of the building whom the landlord had known possessed a firearm and had exhibited strange behavior. Nevertheless, the *Davis* court concluded that no evidence existed showing that the tenant had ever threatened others with any physical violence, and the tenant's ownership of a firearm did not itself "invite speculation that she was actually disposed to use it" against others. *Davis*, at 1406. Consequently, the landlord owed no duty to the victim because it was not foreseeable that the tenant's odd behavior and possession of a firearm would lead to a fatal shooting.

The extent to which a duty to the victim arises is the result of a judicial balancing act. The court will examine the magnitude of the harm versus the ease with which the landlord could have taken precautions to avoid the harm. In other words, courts will consider the closeness of the connection between the defendant's conduct (or, in most instances, lack of action) and the injury.

Once a duty is established, a plaintiff may have difficulty in establishing that a breach of duty caused the injury. This difficulty may be seen in the recent decision of *Saelzler v. Advanced Group 400*, 25 Cal. 4th 763 (2001). In that case, the court found for the owner because the plaintiff could not prove that a lack of security proximately resulted in the sexual assault suffered by the victim, a Federal Express employee making a delivery at the owner's apartment complex. Since the plaintiff could not establish that the assailants did not already have access to the building (i.e., the assailants could have been residents of the apartment complex in which the assault took place), the lack of security could not be shown to have proximately caused the injury. The court noted that even if an owner patently fails to provide a safe building, that failure must still be shown to have directly caused the injury. To hold otherwise would be "contrary to the recognized policy against making landowners the insurer of the absolute safety of anyone entering their premises." *Saelzler* at 780.

To the extent a plaintiff establishes that the landlord owed a duty, the duty was breached and the breach resulted in harm to the plaintiff, the owner is obviously subject to significant exposure. Accordingly, an owner should be sure to examine its property frequently and correct any problems promptly. Consistent repair and maintenance of exterior lighting, surveillance cameras, and locks are obvious items requiring constant vigilance. If a criminal act occurs, tenants should be promptly notified of the incident in a manner that creates cautious behavior but not undue alarm. A written record of responses, including advice that may have been provided by local law enforcement, as well as the actions taken by law enforcement, should be maintained. It is important to act prudently, but not to overreact.

With respect to the employment of security guards, for example, the *Ann M.* court noted that providing security guards places a great burden on the landlord and requires a high degree of foreseeability that can "rarely, if ever... be proven in the absence of prior similar incidents of violent crimes." *Ann M.* at 679. If a property owner has not previously engaged a security guard service, care should be taken if the contemplated engagement is in response to a single incident. Once the service is under contract, the owner could arguably be liable if the service is terminated and a subsequent criminal act resulting in injury occurs.

In addition, while a landlord does not have a general duty to monitor the strange behavior of its tenants, a landlord does have a duty to investigate when it knows, or should reasonably know, that a tenant in its building poses a risk of harm to others. While a landlord must be careful not to overreact and expose itself to wrongful eviction liability, a landlord should conduct reasonable investigations of that tenant's activities on the premises to the extent the circumstances require such investigations. A landlord's right to enter the premises for periodic inspections and the allocation of liability between landlord and tenant should be addressed in the lease.

A landlord may determine what measures the owners of similar property within the vicinity have implemented in response to any threats against safety. Obviously, it is critical to maintain comprehensive general liability insurance with coverage for each occurrence in an amount that will adequately protect the ownership. Leases may provide that the costs of insurance, and often the deductible amounts, can be passed through to the tenants as operating expenses. Lastly, an owner should ensure that its lease gives it the right, but not the obligation, to implement security measures and include the resulting costs in operating expenses for which the tenant pays its pro rata share.

Protecting tenants and visitors against criminal acts of third parties or tenants is a challenge for a building owner and its manager.

Protecting tenants and visitors against criminal acts of third parties or tenants is a challenge for a building owner and its manager. Over the years, California courts have managed to formulate guidelines that assist building owners in the exercise of prudent business judgment. In light of the terrorist attacks on the World Trade Center, however, a building owner's challenge to protect tenants and visitors has been made much more difficult. It remains to be seen whether the guidelines established by case law will provide the same level of assistance to a building owner as they did prior to September 11.

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most major property insurance carriers in the United States will likely exclude terrorist acts from coverage in an all-risk policy. With that exclusion comes changes to the way landlords and tenants conduct business. Discussed below are selected aspects of leasing that will likely be altered, or at least revisited, as a result of the exclusion of terrorist acts from coverage.

To adjust to the new reality of living with terrorism, the insurance industry will redefine the risks to be covered by future policies.

Gross Leasing. The tragedy of September 11 demonstrated the risk to a landlord of using a gross lease with a base year. For leases with a base year of 2003 or 2004 for space in buildings that are about to start construction, a landlord using a gross lease would have quoted a rental rate based on a projection of the operating expenses in 2003 or 2004. Under normal circumstances, the landlord's projections are often very close to the actual expenses. However, a landlord who agreed to provide pre-September 11 all-risk coverage now finds itself in the predicament of first trying to find out whether or not such insurance can be obtained and then, if it can be obtained, how much the landlord will have to pay for it.

Some people believe that terrorist coverage will be obtainable pursuant to one form of governmental program or another, but those insurance costs will be far in excess of what the landlord would have anticipated paying when it quoted the gross rental rate. If a net lease were used, then this would not be an issue because the cost of such insurance coverage would be passed on to the tenant.

As new leases are structured, the landlord and tenant should make sure that their leases provide that if any insurance required to be obtained by the landlord or tenant is not available on a commercially reasonable basis, then the landlord or tenant, as applicable, will be excused from obtaining such insurance until such time as the insurance is again available on a commercially reasonable basis.

Rent Abatement. The September 11 tragedy highlighted the need to scrutinize the rent abatement provisions of a lease. In a tragedy where rescue efforts in a particular building result in the closure of surrounding buildings, are tenants entitled to rent abatement for the time that they are unable to use their buildings? Typical New York City leases specifically deny any rent abatement to tenants except where their own buildings are destroyed and the premises are rendered unusable. When buildings are not destroyed, the tenants generally are obligated to continue paying rent.

A typical all-risk policy provides a limited period (generally ten days to three months) during which the insured landlord is entitled to rental continuation insurance proceeds in the event ingress and egress are denied to its building by order of the government. Such proceeds, however, are not available to the landlord if the tenants are not entitled to rent abatement. In such a case, tenants end up subsidizing their landlord for an insured event. To eliminate this subsidy, at a minimum, tenants should always insist (and a landlord should not object) that tenants get the benefit of rent abatement any time that the landlord is otherwise entitled to receive rental continuation insurance proceeds under the landlord's insurance policy.

Capital Expenditure Pass-Throughs. The typical "even-handed" lease should provide that the landlord may not pass through the cost of capital expenditures except for (i) capital expenditures that result in cost savings and (ii) capital expenditures made pursuant to newly enacted laws. In each case, the capital expenditure costs are amortized over the useful life of the capital item and the annual amortization cost is passed through to the tenants.

As the United States becomes more safety conscious, tenants are going to insist on the implementation of increased safety and security measures. The security measures to be implemented may require substantial capital expenditures. As a consequence, a landlord is likely to insist upon the inclusion of a third exception to the general rule that capital expenditures are not passed through to tenants, namely, capital expenditures to provide increased safety and/or security to the tenants of the building.

Tenant Improvements. A landlord and its tenants must also consider who should receive the insurance proceeds with respect to tenant improvements where the building is damaged and the lease terminates because the building cannot be rebuilt within the agreed-upon time period for restoration. To the extent that a landlord provides the entire tenant improvement allowance, and to the extent that tenants do not spend more than the entire allowance on tenant improvements, the landlord could make a claim that it is entitled to the proceeds from the tenant improvement insurance. Tenants, on the other hand, can argue that they are entitled to such proceeds on the theory that the tenant improvement allowance was not free but was built into the rental rate.

However, where the tenants spend significantly more than the tenant improvement allowance on the tenant improvements, the equities clearly appear to be with the tenants. If, for example, a tenant improvement allowance is $25 per square foot and a tenant spent $300 per square foot on the tenant improvements, then, at a minimum, that tenant would arguably be entitled to at least $275 per square foot of the proceeds from the tenant improvement insurance. The tenant would need that money to rebuild its tenant improvements at another location. Since the lease governs the rights of the parties with respect to sharing tenant improvement insurance proceeds, it behooves both a landlord and its tenants to negotiate these terms carefully.

Conclusion. Without commenting on the merits of such a position, most people believe that leases are duller than stone posts, and that within a lease document, the insurance and casualty provisions are duller still. Most people also have a hard time believing that a lawyer could add value in connection with the lease negotiation process. However, the tragedy of September 11 and the insurance industry's likely response underscore the importance of allocating risks and rights by careful negotiation. Both landlords and tenants should immediately have their leases reviewed by competent and experienced counsel to at least address the issues that are raised in this article.

[T]he tragedy of September 11 and the insurance industry's likely response underscore the importance of allocating risks and rights by careful negotiation.

NOTE: This article was derived from an article presented by the authors to the Building Owners and Managers Association of Greater Los Angeles.

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(*Lease* continued from page 3)

interests. Often these securities are subject to holding periods or "lock-up" agreements that prevent landlords from redeeming their securities, even if there is a market for them. Additionally, to the extent the securities have not been registered, they are considered restricted securities that generally must be registered before they can be sold. If landlords do not wish to incur often significant costs to register their shares, and they fail to negotiate for piggyback registration rights for their shares at the same time the large stakeholders register their shares for sale, landlords may be subject to additional holding periods under federal and state securities laws before they can sell such shares.

Subleases. Another major challenge arising out of the dot-com era is the prolific subleasing of space by tenants. Because many well-funded, start-up companies rapidly expanded, causing the premises originally leased to become inadequate, tenants often subleased their spaces to new tenants. In some cases, the new tenants outgrew their spaces and, in turn, subleased the spaces to additional tenants. The result is that landlords may be faced with a multitude of tenants and subtenants, some of whom are suffering financially and others who are still performing.

In recent months, it has not been unusual to find subtenants who have been paying rent regularly to their sublandlords to find that their sublandlords have failed to make timely payments of rent to master landlords. These subtenants are often surprised when they are served with 3-day notices to pay rent or quit, or served with unlawful detainer actions as a result of incurable defaults by their sublandlords. Consequently, the challenge for landlords is to cull through the defaulting tenants, resolve legal issues as they arise and still retain performing tenants. In that regard, careful landlords will need to know who currently occupies the premises that were originally leased to properly serve legally sufficient notice to all occupants of the premises, which is a prerequisite to resolving tenancy problems as quickly as possible and readying spaces for re-leasing to new tenants.

Conclusion. It has been written that those who forget the past are condemned to repeat it. The dot-com era will be hard for anyone to forget, especially landlords. So as not to repeat the recent past, perhaps the lingering memories of the dot-com era will assist landlords in structuring leases to meet the current business cycle.

Eric Kremer is a partner in the San Diego office and may be contacted via e-mail at ekremer@pillsburywinthrop.com or by phone at (858) 509-4021.

Special Invitation

The Global Real Estate Practice Group of
Pillsbury Winthrop LLP cordially invites you to attend:

Curing Insecurity:

Prescriptions for Landlords and Tenants After September 11th

A roundtable discussion among Kroll Associates' Sergio A. Robleto, Managing Director Western Region; Gregory S. Boles, Director of Global Threat Management; and Pillsbury Winthrop LLP Partners Michael Meyer, Lew Feldman and Deborah Thoren-Peden.

A complimentary continental breakfast will be served.

Tuesday, December 11, 2001
7:30 a.m. to 9:00 a.m.

Pillsbury Winthrop LLP
725 South Figueroa Street
Suite 2800, Multi-Purpose Room
Los Angeles, CA 90017

Seating is limited. RSVP by December 6 by calling 213-488-7228 or e-mailing lmora@pillsburywinthrop.com.

(*Private* continued from page 2)

Generally, the market operates on a quarterly earnings basis. Because entitlement and construction of an active senior project spans over several quarters, public investors would receive no return for two or more years. Becoming a closely-held company allows FountainGlen to attract capital from long-term institutional investors with the patience to wait for substantial returns on investments. Management can also redirect substantial funds earmarked for the costs of being public (such as accounting, legal and shareholder communications costs) to new product development. "Our substantial experience with active senior communities at Pacific Gulf Properties helped us recognize the tremendous potential of and unmet need for active senior housing, and the good we could accomplish. Our investors share our vision," said Mr. Carpenter.

Marc Halle, Principal of Prudential Real Estate Investors, a leading investor in the new company, added, "PREI is glad to be a part of this outstanding venture. Our involvement with FountainGlen Properties and its dedication to quality rental housing for active seniors provides us with an outstanding investment opportunity, as well as providing necessary housing for this important market segment."

The merger of Pacific Gulf Properties into FountainGlen is a clear display of going private and doing good. The merger has yielded substantial benefits to the former shareholders of Pacific Gulf Properties, and will undoubtedly prove beneficial for the active seniors who reside in a FountainGlen community.

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