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Article Highlights

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"Green" Leasing: Landlord and Tenant Perspectives

by Eric A. Kremer and Carmela D. Nicholas

As the global emphasis on carbon footprint reduction and sustainability measures continues to increase, so will the prevalence of "green" provisions in commercial leases. For both landlords and tenants, business, marketing and public relations reasons are as likely as environmental interests to drive the "green" lease trend. From the landlord's perspective, a building that achieves a certain sustainability rating may have a competitive marketing advantage over buildings that have not achieved "green" status, and the implementation of environmentally friendly measures such as installation of energy-efficient LED lights may serve to reduce operating expenses for a property. A recent study showed that buildings that are certified under the U.S. Green Building Council's Leadership in Energy and Environmental Design ("LEED") rating system command higher rents and have greater occupancy rates than non-LEED-certified buildings.[1] Landlords are also faced with new federal, state and local regulations that may require compliance with "green" initiatives, such as the requirement to recycle construction waste from tenant improvement installations.

Likewise, a tenant may wish to market itself as conducting its operations in environmentally friendly buildings that promote sustainability and "green" practices. There is also a growing recognition that LEED-certified properties can lower certain operating expenses that are typically passed through to tenants by commercial landlords.

The result of these trends is an increasing interest in incorporating "green" lease provisions into commercial leases, and a need for building owners and their tenants to understand the impact of such provisions. This article discusses a few of the more common "green" lease provisions, such as those related to operating expenses, negative and affirmative covenants, and assignment and subletting, and some attendant issues to consider when negotiating a commercial lease, whether as a landlord or as a tenant.

Operating Expenses

Operating expenses are often one of the most negotiated issues in commercial leases. Commercial landlords desire to pass through to tenants as much of the operating expenses of the property as possible, and tenants desire to limit exposure to unanticipated or unwarranted operating costs of the landlord. As a result, certainty in what types of "green" costs may be passed through to tenants, or must be absorbed by the landlord, is important to both parties.

Many standard operating expenses charged to tenants on a pass-through basis already include aspects of "green" compliance, such as use of fluorescent light fixtures and recycling of office trash. However, given the likelihood of new environmentally friendly technologies, practices and regulations, a landlord may wish to broaden the range of environmental standard compliance costs that constitute operating expenses to include the costs of seeking or

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maintaining a certain sustainability rating for a commercial building. Even if a building is not currently certified under a specific rating system, the provision gives the landlord the option to seek such certification in the future and pass through the costs to its tenants. Given that tenants are increasingly electing to require that their leased premises satisfy LEED or similar environmental compliance ratings, an express inclusion of such costs in operating expenses gives the tenant assurances that the property will continue to meet such standards and may protect the tenant from incomplete or ineffective efforts. It also gives the landlord a cost basis to implement and maintain the level of sustainability compliance that its tenants require. However, inclusion of such a provision can be contentious where the landlord is attempting to retrofit a building for environmental certification and to pass through such costs to existing tenants. These tenants may take the position that, because the building was not certified at the time of lease execution, any attempts by the landlord to pass through these costs as project operating expenses are improper.

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A landlord's costs of initially meeting a "green" compliance standard include maintaining, reporting or commissioning a building in order to conform to a certain sustainability rating system or other standard.[2] It typically would be appropriate for initial certification costs to be amortized under GAAP or the landlord's accounting principles, consistent with the amortization requirements for capital expenditures that are included among operating expenses. However, absent some resulting measurable reduction in operating expenses, tenants may question a landlord's ability to pass through the costs of its efforts to update or recommission a building.[3]

The following is a sample landlord-friendly "green" operating expense clause, to be included with the other operating expense items:

> "In addition to the above costs, Operating Expenses shall include all costs and expenses incurred by Landlord in maintaining, managing, reporting, commissioning and recommissioning the Building so as to conform with the U.S. EPA's ENERGY STAR® rating, the Green Building Initiative's Green Globes™ for Continual Improvement of Existing Buildings, or the U.S. Green Building Council's Leadership in Energy and Environmental Design ("LEED") rating system, or any other applicable sustainability rating or standard of the Building, or of applying, reporting and commissioning the Building to seek certification under any such rating system or standard; provided, however, the cost of such applying, reporting and commissioning of the Building or any part thereof to seek certification shall be amortized in accordance with GAAP [or Landlord's standard accounting principles]."

However, a tenant will wish to, and should, limit its obligation to reimburse the landlord for any "green" operating expenses and ensure that its overall costs do not increase. Even a "green" tenant is unlikely to agree to absorb cost increases as a result of seeking certification or maintaining a sustainability rating for the buildings that it leases, if such increases are not offset with savings through greater energy efficiency. A cost-neutral limitation on the landlord's ability to pass through sustainability costs is particularly appropriate where the building was not certified at the time that the tenant entered into the lease or where the landlord attempts to amend the original lease to add sustainability costs to the list of operating expenses.

Furthermore, the tenant should require the landlord to deliver evidence of cost savings or cost neutrality achieved through sustainability measures, including evidence of year-over-year (or base year, where applicable) comparisons.[4] Such evidence should be delivered on a regular basis, such as annually, and, at a minimum, concurrently with the delivery of the landlord's annual reconciliation statements. The tenant should have the right to audit the landlord's records relating to the building's certification and sustainability rating costs. The tenant also may want to incorporate a percentage limitation on pass-through expenses for sustainability efforts. For example, the tenant could require that sustainability costs not exceed a certain percentage of overall operating expenses, with any excess costs automatically being excluded from operating expenses for which the tenant is responsible. A tenant with a base year for operating expenses also can negotiate for increases in the categories of base year expenses if a new sustainability-related cost is introduced in later years so that a baseline cost for the measure is established and the tenant only pays for increases over the remaining lease term.

Restrictions and Affirmative Covenants

In order to achieve or maintain a certain sustainability rating or standard for a building, a lease also needs to contain covenants that require the parties to comply with sustainability practices and programs. From the landlord's perspective, these provisions should be broad and general enough to allow flexibility, such as general restrictions on using or operating the premises in any manner that will cause the building not to conform with the landlord's sustainability practices or the building's applicable rating system. From the tenant's perspective, such operating covenants should be tailored so that they do not interfere with the tenant's business operations in any material respect or increase operating costs for its business.

In order to achieve or maintain a certain sustainability rating or standard for a building, a lease also needs to contain covenants that require the parties to comply with sustainability practices and programs.

A general covenant on compliance may be supplemented by more specific covenants relating to construction, carbon reduction, and recycling and waste management. The following are sample landlord-friendly tenant covenants:

> "**LEED Rating.** The Building and the Project are or may become in the future certified under the LEED rating system. Landlord's sustainability practices address whole-building operations and maintenance issues, including chemical use; indoor air quality; energy efficiency; water efficiency; recycling programs; exterior maintenance programs; and systems upgrades to meet green building energy, water, indoor air quality and lighting performance standards. All construction and maintenance methods and procedures, material purchases and disposal of waste with respect to the Project shall be in compliance with minimum standards and specifications in furtherance thereof, in addition to any requirements under applicable Laws with respect thereto."
>
> "**Energy-Efficiency Measures.** Tenant shall not waste electricity, water, heat or air conditioning, or other utilities or services, and agrees to cooperate fully with Landlord and comply with any applicable Laws to assure the most effective and energy-efficient operation of the Building. Tenant covenants to cooperate with Landlord in connection with satisfying Landlord's compliance requirements with respect to any sustainability measures implemented by Landlord, including, but not limited to, providing Landlord with monitoring data and reporting duties related to the Premises. Tenant shall use proven energy and carbon reduction measures, including energy-efficient bulbs in task lighting; use of lighting controls; daylighting measures to avoid overlighting interior spaces; closing shades in the Premises to avoid overheating the space; turning off lights and equipment at the end of the work day; purchasing ENERGY STAR® qualified equipment, including, but not limited to, lighting, office equipment, commercial and residential quality kitchen equipment, vending and ice machines; and purchasing products certified by the U.S. EPA's Water Sense® program."
>
> "**Recycling and Waste Management.** Tenant covenants and agrees, at its sole cost and expense, to (1) comply with all present and future Laws, orders and regulations of the Federal, state, county, municipal or other governing authorities, departments, commissions, agencies and boards regarding the collection, sorting, separation and recycling of garbage, trash, rubbish and other refuse (collectively, "trash and recyclables"); (2) comply with Landlord's recycling policy as part of Landlord's sustainability practices where it may be more stringent than applicable Laws; (3) sort and separate its trash and recyclables into such categories as are provided by Law or Landlord's sustainability practices; and (4) place each separately sorted category of trash and recyclables in separate receptacles as directed by Landlord. Landlord reserves the right to refuse to collect or accept

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> from Tenant any trash and recyclables that are not separated and sorted as required by Law and to require Tenant to arrange for such collection at Tenant’s sole cost and expense, utilizing a contractor approved by Landlord. Tenant shall pay all costs, expenses, fines, penalties or damages that may be imposed on Landlord or Tenant by reason of Tenant’s failure to comply with the provisions of this Section.”

The tenant will want to ensure that it is not held to a higher standard than other tenants in the building or project, and to require reciprocal “green” covenants from the landlord. The tenant should limit compliance measures to those that do not impose greater costs or liability on the tenant, or adversely impact its use or enjoyment of the premises, and require the landlord to deliver written specifications regarding any rating system as a condition to the tenant’s obligation to comply with such rating system. In addition, the scope of the sustainability covenants should be restricted to the tenant’s use of the premises only; the covenants should not apply to the tenant’s operations at any other properties or facilities.

Assignment and Subletting

Sustainability ratings also should be considered in the assignment and subletting provisions of the lease. Although the original tenant (and customarily any assignee) is required to comply with any “green” covenants under the terms of the lease, it typically would be a matter of negotiation between the subtenant and the tenant as to those lease provisions with which the subtenant must comply. A landlord will want to require that any sublease specifically obligates any subtenant to comply with all “green” provisions of the master lease. The landlord also may wish to assess the likelihood that a proposed assignee or subtenant will, in fact, be able to comply with such covenants. If the proposed assignee’s or subtenant’s use of the premises may or will cause the building not to conform to the sustainability practices of the landlord and the obligations of the tenant or subtenant under the lease, this factor should be deemed a reasonable basis for the landlord’s disapproval of any proposed assignee or subtenant.

A landlord will want to require that any sublease specifically obligates any subtenant to comply with all “green” provisions of the master lease.

The tenant will want to add language providing that a violation due to the proposed assignment or subletting must be probable (rather than possible) before any disapproval based on the compliance capabilities of the proposed assignee or subtenant would be deemed reasonable and that any proposed use by the assignee/subtenant that complies with the permitted uses specified under the lease automatically constitutes compliance with the applicable sustainability rating or standard.

Miscellaneous

There are numerous other provisions that the parties may wish to include in the lease in order to achieve or maintain certain sustainability ratings or standards. “Green” requirements may be incorporated into project rules and regulations. As most leases allow the landlord to adopt new rules and regulations at any time during the lease term, tenants will want to confirm that rules relating to “green” compliance are subject to the same restrictions or requirements for any change in rules or regulations that the tenant has negotiated in its lease. Tenant improvement work also may be subject to a landlord’s requirement that the tenant improvement allowance be used to maintain and seek LEED for Commercial Interiors certification for a tenant improvement build-out. A tenant may be required to maintain such certification for its alterations during the lease term. In addition, a “green” tenant may wish to require the landlord to seek LEED certification for a new building, particularly if it is a build-to-suit lease.

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The provisions highlighted above are only a few of the issues that landlords and tenants are likely to face in the near future as environmentally oriented compliance standards become the norm in commercial buildings. Landlords will want to preserve or achieve a certain rating system and have the ability to pass through related costs to the tenants, while tenants will be concerned about absorbing increased costs associated with operating expenses and performing obligations relating to sustainability measures.

Given the increasing awareness of sustainability and environmental practices and the impact these practices will have on leasing, landlord and tenants need to be mindful of "green" lease provisions. Because it is best to address "green" lease provisions at the outset of lease negotiations and avoid conflicts at a later date, regardless of whether the concerned party is the landlord or the tenant, both landlords and tenants should seek advice from legal, design and construction experts early in the lease negotiations so that both parties can mutually work toward a "green" lease that achieves long-term sustainability.

Endnotes

1 *CoStar Study Finds LEED, Energy Star Buildings Outperform Peers*, Andrew C. Burr, CoStar Group (March 26, 2008).

2 Certain rating systems and standards require that owners document the performance of their buildings, through self-reporting mechanics and/or by a third-party commissioning authority.

3 Reasons for recommissioning a building may include changes in the configuration of interior space that interfere with ventilation, plumbing repairs or replacements where pipe insulation may have been removed or changes in lighting needs as a result of the construction of new buildings.

4 Note that under the draft regulations recently issued by the California Energy Commission under AB 1103, commercial real estate owners must disclose energy benchmarking data commencing on July 1, 2012, for buildings larger than 50,000 square feet, January 1, 2013, for buildings between 10,001 and 49,999 square feet, and July 1, 2013, for buildings between 5,000 and 10,000 square feet. California Energy Commission, *Draft Regulations for AB 1103*, September 12, 2011. Available at http://www.energy.ca.gov/ab1103/documents/index.html.

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Scratching the Surface: Understanding the Potential Impact of Minerals Rights on Your Texas Loan

by James S. Lloyd

Texas oil and gas law presents unique issues for real estate secured lending. In Texas, the mineral estate can be severed from the surface estate, resulting in a separate fee estate with rights to use the surface for purposes of exploring and extracting minerals. Over the past decade, energy prices, combined with new technologies such as hydraulic fracturing, have resulted in increased exploration and development in urban areas, typified by the Barnett Shale play in North Texas. Lenders should be aware of the potential impact of such exploration and development on their real property collateral.

Severance of the Mineral Estate

Prior to severance, an owner of real property in Texas owns both the surface and all of the oil, gas and other minerals beneath the surface. For a lender whose loan is secured by a lien on real property that has not been severed, the lien attaches to all of the real property described in the security instrument, including the oil, gas and other minerals below the surface (even if the same are not expressly referenced). Conveyance or leasing of the mineral estate by the borrower will be subject to the terms of the loan documents.

If the mineral estate has been severed, however, a security instrument imposing a lien on the surface estate has no effect on the mineral estate. Severance results in the existence of two separate fee estates—the mineral estate and the surface estate—and these two estates exist independently. Each is subject to its own ad valorem taxes, and may be conveyed and financed separate and apart from the other. The mineral estate can be severed by either conveyance or reservation (e.g., express language in a deed conveying the surface estate that reserves all or a portion of the minerals to the grantor) in an instrument satisfying statute of frauds requirements and other requirements applicable to transfers of real estate. Unless the surface owner also owns some portion of the mineral estate, a surface owner has no rights at all with regard to the minerals, including no right to explore, develop, lease, convey or collateralize the mineral estate. Indeed, doing so could result in an action for slander of title, trespass, conversion or other claim against the surface owner by the owner of the mineral estate or its lessee.

How can a lender determine whether the property securing its loan has been severed? As a general rule, because of the long history of oil and gas development in Texas, one can assume that the surface and mineral estates for most real property in Texas have been severed, but a lender's negotiations with the borrower should include discussions to confirm the status of the property, and appropriate representations and warranties should be included in the loan documents regarding such information provided by the borrower. Proper title examination also is crucial. As severance instruments typically are recorded, a title commitment for a lender's policy of title insurance should include the severance instrument in the listing of exception documents. Subsequent conveyances of the mineral estate, or partial interests therein, if recorded, also will be included in the title commitment.

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The Mineral Estate and Surface Estate

The owner of the mineral estate has, among other rights, the exclusive right to develop and lease the mineral estate. Additionally, under Texas law, the mineral estate is the dominant estate, and the mineral estate owner has an implied easement to use the surface and subsurface as may be reasonably necessary to explore, develop, produce, transport and store the minerals from its property. In other words, a surface owner's use of the surface estate is subordinate to the mineral owner's use of the surface to the extent such use is reasonably necessary to exploit the minerals. As a general rule, provided that a mineral owner's use of the surface is reasonably necessary, a mineral owner will not be liable to the surface owner for damage to the surface estate resulting from the mineral owner's activities. Surface uses by the mineral owner that have been confirmed by Texas courts as reasonable include conducting seismic testing, building storage tanks and roads, and using water from the property. The mineral owner also may enjoin actions by the surface owner or its lessees that interfere with the reasonable use, operation and development of the mineral estate.

The requirement that the mineral owner's activities on the surface estate be reasonably necessary provides surface owners with some protection. To the extent such activities are not reasonable, or if the mineral owner's negligent acts damage the surface, the surface owner may be able to enjoin the action and/or seek damages. Texas courts also have limited the mineral owner's rights by requiring that the mineral owner accommodate existing surface uses where reasonably possible. It should be noted, however, that this doctrine, known commonly as the accommodation doctrine, requires that the mineral owner accommodate only existing uses, not future uses, and that liability is imposed on the mineral owner only if there are established alternate industry practices that can be used and such alternate practices are not unreasonably expensive. Lenders should be aware of the limitation of the accommodation doctrine in situations in which the real property collateral will be subsequently developed following the closing of the loan (as with construction loans), but oil and gas activity, including leasing, already exists on the property. Although the outcome in any such situation will depend on the specific facts at hand, Texas courts have generally concluded that surface development not under way when the exploration or extraction of minerals commenced is not an existing use and therefore does not have to be accommodated.

Lenders should carefully examine the terms of surface waivers in oil and gas leases, as the waiver language in such agreements does not always extend to benefit the successors or assigns of the surface owner.

Additional Restrictions on Mineral Owner's Right to Use the Surface Estate

Although the general rule in Texas is that the mineral owner may utilize the surface estate to the extent reasonably necessary to exploit the minerals beneath the surface, there may be additional restrictions that limit a mineral owner's rights, including any provided for in the severance instruments or other agreements between the surface and mineral owners, as well as related state or local regulations and ordinances.

Contractual Restrictions

A mineral owner's rights are established at the time of severance, and such rights may be contractually restricted in the severance instrument. Again, title review is crucial as the examination of the severance instrument and subsequent instruments will provide a lender with the scope of the mineral owner's rights to use the surface estate. Contemporary severance instruments, whether through conveyances or reservations, often include restrictive covenants whereby the grantee's right of access to and use of the surface estate is limited to a particular area or altogether prohibited. Lenders will find, however, that such restrictions are relatively rare in earlier severance instruments, and mineral owners under such instruments typically will have the broad rights regarding surface use discussed earlier. Lenders should carefully examine the terms of surface waivers in oil and gas leases, as the waiver language in such

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agreements does not always extend to benefit the successors or assigns of the surface owner. In such cases, a lender may not receive the benefit of the waiver if it forecloses on the surface estate or receives the property from the borrower by a deed in lieu of foreclosure.

Exploration and drilling also may be limited by restrictive covenants running with the property, such as declarations or similar instruments. Such restrictions, however, must predate the mineral severance in order to restrict the mineral owner; if not, the mineral estate is not subject to the restriction unless the mineral owner subsequently ratified or otherwise accepted it. Because of the history of oil and gas development in Texas, severance of the mineral and surface estate typically will predate the recording of restrictive covenants prohibiting drilling or other activities on the surface. Careful examination of title documents is necessary to determine the rights by and between the surface and mineral owners.

Regulations and Ordinances

Drilling is regulated by the Texas Railroad Commission (TRRC), and a mineral owner must comply with the TRRC's regulations and requirements regarding surface and subsurface use. Although discussion of these regulations and requirements is beyond the scope of this article, lenders should be aware that the TRRC must approve the location of all oil and gas wells in Texas. Additionally, some municipalities have imposed "no drilling" ordinances or comparable zoning limitations within their jurisdictions. Review of applicable ordinances and zoning is crucial to determine the potential risk that drilling may have on the collateral. Lenders should keep in mind, however, that TRRC requirements and city ordinances and zoning are subject to change, and the possibility always exists that requirements and restrictions on drilling could be altered, repealed or be subject to variance such that activities previously limited or prohibited are made available to the mineral owner.

Review of applicable ordinances and zoning is crucial to determine the potential risk that drilling may have on the collateral.

Mitigating the Risks of Surface Use by the Mineral Estate Owner

Once a lender has confirmed that the mineral estate and surface estate have been severed and identified the scope of the mineral owner's rights, a number of strategies exist for a lender to mitigate the potential impairment of its collateral.

Surface Waivers

If the severance instrument allows unfettered use of the surface estate and examination of title does not reveal a comprehensive surface waiver by the mineral owner, a lender may require that the borrower deliver a surface waiver from the owner or owners of the mineral estate and any lessees under existing leases, prohibiting either the mineral owner or its lessees from entering on or using the surface of the property for purposes of exploring for or extracting minerals. As a practical matter, however, obtaining a surface waiver from the mineral owner or owners can be difficult. In a typical instance, title in the mineral estate may have been divided and conveyed any number of times, whether by instrument, probate or intestacy, and often the conveyance documents are not recorded in the real property records. Obtaining surface waivers from tenants under oil and gas leases, or amendments to such leases to extend the benefit of existing surface waivers to the surface owner's successors and assigns, is usually less time-consuming and costly, although, in some instances, lessees are reluctant to give up surface rights and may heavily negotiate the terms of a surface waiver.

Loan Documents

Lenders also should ensure that the loan documents adequately address potential damage to the collateral that may arise as a result of a mineral owner using the surface estate. Indemnity and insurance provisions and the use of

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escrows or reserves can be drafted to mitigate potential diminution in the value of the collateral resulting from the mineral owner's exploration and extraction of minerals. In instances where drilling activities already have occurred on the property, or are likely to occur, a lender may consider requiring environmental insurance to ensure that funds are available to address contamination should it occur.

Title Policy Endorsements

The Texas Department of Insurance has promulgated endorsements that provide coverage to a lender under its title policy, up to its policy amount, for damages resulting from a mineral owner's exercise of its rights to use the surface estate. Coverage under the Restrictions, Encroachments, Minerals Endorsement (T-19) includes coverage for damages to existing improvements resulting from the future exercise of any right to use the surface for the extraction or development of minerals excepted in the description of the covered property or excepted in Schedule B of the title policy. Lenders should note that the T-19 covers only damages to existing improvements caused by activities after the date of the policy. Future improvements are not covered, nor are damages that existed at the time the title policy was issued. It also should be noted that a title company has the ability to exclude the insuring provision if it determines that the risk posed by the mineral exceptions are not acceptable. Despite these qualifications, issuance of a T-19 endorsement can provide a lender with assurance that potential damage to the collateral resulting from surface use by a mineral owner will be covered, up to the amount of the title policy. For a lender's policy, the cost of the endorsement is 10 percent of the premium amount for the base policy.

If a title company takes a general exception to mineral rights in the title policy, upon the insured party's request, the title company must issue a Minerals and Surface Damage Endorsement (T-19.2 and T-19.3). The T-19.2 endorsement applies to residential property of less than one acre and any property used or intended to be used for office, industrial, retail, mixed retail/residential or multifamily purposes. The T-19.3 endorsement applies to all other real property. Both endorsements provide coverage against damage resulting from the future exercise of any rights existing as of the date of the title policy to use the surface of the covered land to extract or develop oil, gas or other minerals, save damage resulting from subsidence, but the T-19.2 endorsement covers current or future improvements (excluding lawns, shrubbery or trees), while the T-19.3 endorsement provides coverage only for current or future permanent buildings. The cost of either the T-19.2 or T-19.3 endorsement is $50.

Mineral rights in Texas can present unique issues for lenders. Understanding the scope of the mineral owner's rights to use the surface estate and taking the actions necessary to mitigate the potential risks posed by such use should be part of every lender's due diligence activities and lending requirements.

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Avoiding Construction Project Failures: 8,000 Romans, 3,000 Greeks, One Lesson

by Jeffrey R. Gans and John A. Fedun

Over two days in 279 BC, Rome fought a bloody battle at Asculum against the Grecian-allied armies of Tarantine, Oscan, Samnite and Epirote. As with all important battles (ancient and modern), the Battle of Asculum was part of a war for control over an enormous parcel of prime real estate on the southern Italian coast known at the time as *Magna Graecia*. Those miles of waterfront property with no zoning restrictions and deepwater access were coveted by every developer from Macedonia to Gaul.

When the joint venture talks broke down, the battle was joined and heavy casualties were suffered on both sides. In the end, the Romans were routed from the field when their line was broken by a charge from the Greeks' armored elephants. But the Romans turned a defeat at Asculum into a victory in the war by inflicting heavy casualties on a Greek army that was far from reinforcements. We remember this event for the wisdom shown by the Greek King Pyrrhus, who famously stated, "If we are victorious in one more battle with the Romans, we shall be utterly ruined."

Attorneys see nearly all of their clients' Pyrrhic victories. Clients, through excellent contract negotiation and drafting, obtain rights to build office buildings, convention centers, stadiums, schools and mixed-use projects worth hundreds of millions of dollars, only to lose the benefit of their early success when red flags are not recognized early and monitored assiduously. Often, the problems come when clients rely on contract negotiation and drafting as a substitute for diligence. Everyone loses something when a good project fails—whether it be money, opportunity cost, time or reputation—regardless of how those failures may be ameliorated by fault, risk-shifting, insurance or indemnity.

Projects fail for myriad reasons that can be avoided when issues are identified early and managed through completion. Here, we discuss three red flag situations that can be identified and addressed in a construction project's early days: (1) unusual contracting arrangements, (2) undue risks revealed during the bid process, and (3) changes in key leadership at the design, engineering, general contracting or construction management firm.

Unusual Contracting Arrangements

Unusual contracting arrangements, whether related to design services or construction management, are red flags. Project owners and their counsel must scrutinize project frameworks that either establish an irregular division of responsibility or place responsibility for dependent tasks on independent entities.

Unusual allocation of design responsibility

When design responsibility falls to two or more architects and/or engineers that each have privity with the owner but not each other, managing the relationships among the design professionals falls to the owner. But the greater involvement an owner has in the "means and methods" of the professionals' services, the greater the chance that the owner may make, or cause the design professionals to make, a mistake because of miscommunication, lack of understanding or other reasons. In the best case, an owner will engage an experienced design project manager, insured against failures and motivated by reputation or liability, for the ultimate responsibility of delivering the final design product.

Unusual allocation of construction management responsibility

When a project is divided by geography or phase among multiple general contractors, the owner becomes the de facto construction manager. Proper management of complex construction is time-consuming and expensive, and the consequences of mistakes can be dire. The management of every complex construction project requires strong leadership to make difficult choices for the good of the project that often advantage one entity at the expense of another. When the entities involved have no contractual relationship with one another, the dispute can quickly become a claim for compensation for the consequent disadvantage. Without proper management, even resources like available staging space or the use of the project crane may not be expended for the good of the overall project. Very few owners employ a sufficient number of experienced people to successfully manage construction projects in-house. (It can be done successfully, but the contractors must be managed carefully and consistently.) As with design management, construction management is best done by an experienced construction manager with experienced staff.

> *Proper management of complex construction is time-consuming and expensive, and the consequences of mistakes can be dire.*

Bid Process

Other red flags may be vigorously waived during the bid process, which is often the proverbial canary in the coal mine. However, if an RFP draws too few bidders, bids that are ultra-lean, or bids far in excess of the expected range, an owner should scrutinize the RFP, the bids and the bidders before selecting a winner.

Too Few Bidders

If the top firms in the field are not seriously competing for an owner's business, there is a problem. Good firms have enough experience and expertise to overcome many design/planning flaws, so if a proposal is too flawed to entice their participation, beware.

Ultra-Lean Bids

Similarly, a construction budget that has too little fee for the actual construction management (as opposed to the money going to the subcontractors to perform the work) means lean staffing and relentless effort by the construction professionals to find a way to profit from the project during construction. While an ultra-lean bid may be attractive for the lower cost and potentially greater profit to the owner, an owner should think critically about whether or not the bidders' incentives will be aligned with the owner's goals.

Bids Far in Excess of the Expected Range

Sometimes, a well-respected firm will submit a bid that is wildly out of proportion to the other bids. This type of response may reflect the bidder's decision not to seriously chase the work by asking for a price driven high by large markups. While it is easy to discard such a proposal as out of bounds, some effort should be made to identify the bidder's motive. That bid may reflect the bidding firm's error, reveal an error in the winning firm's low bid or highlight aspects of the work (such as timing, legal requirements, etc.) that the owner may not have previously considered.

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Changes In Key Leadership

A third red flag is recent changes in key leadership at the firms that are critical to a project, including architects, engineers, construction managers and general contractors. Even in the post-modern age, project development from design to final construction is a human endeavor, and little matters more than the talents of the people who are responsible for the work.

Of course, a wise owner will investigate the reputation and skills of the staff proposed to lead its project's efforts. Checking references and interviewing prior to executing a contract, rather than waiting to meet the staff at the first project meeting, can be worthwhile. After all, calling off a wedding after the invitations are mailed is hard, but it's a cakewalk compared to a divorce.

Furthermore, when previously touted talent leaves a firm that is being considered for a project, the owner should ask about, and independently verify, the circumstances of the departure. An owner should do this even if the departed employees were not supposed to be staffed on the project, in case the employees' departure is a sign of other trouble in the firm.

Conclusion

The risk areas discussed above can be addressed by good legal agreements, written and negotiated by experienced counsel. But no matter how well written, contracts merely shift risks; they do not eliminate them. Your chances for a successful project increase significantly if risks are recognized and avoided, instead of merely being shifted to another party. Conversely, if the project fails, everyone loses something, no matter the reason or how the risk was allocated. And despite his fame, no one wants to emulate King Pyrrhus. If a project owner recognizes and proactively addresses the red flags described in this article, he or she will go a long way toward a true, rather than a Pyrrhic, victory.

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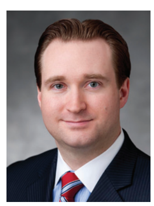

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California's Post Redevelopment Agency Landscape

by Robert C. Herr, Noa L. Clark and Paul C. Levin

On December 29, 2011, the California Supreme Court upheld legislation that fundamentally changes redevelopment law in California. The court upheld Assembly Bill X1 26 (AB 26), eliminating all redevelopment agencies in California, while overturning Assembly Bill X1 27 (AB 27), which would have allowed redevelopment agencies to continue operations if the agencies made certain payments to the state. As a result, all of California's approximately 400 redevelopment agencies dissolved as of February 1, 2012, without the option to make payments to the state to continue operations.

The dissolution of California redevelopment agencies has created many complexities and unanswered questions regarding the mechanics of dissolution, and the status of redevelopment areas and developments. This article briefly summarizes the current status of the law and describes a few of the many aspects of the dissolution process that are now in focus for many California developers, lenders and other real estate stakeholders.

California Redevelopment Association et al. v. Matosantos et al.

AB 26 and AB 27 were enrolled on June 29, 2011, during an extraordinary legislative session held to address California's fiscal emergency. Governor Jerry Brown predicted that the bills would provide approximately $1.7 billion to the state during the 2011-2012 fiscal year and $400 million to the state in each subsequent fiscal year.

In response, the California Redevelopment Association and the League of California Cities, joined by several mayors, filed suit, claiming the statutes violated the California Constitution. Specifically, petitioners alleged the statutes violated Section 25.5 of Article XIII of the California Constitution, enacted by the voters in 2010 as Proposition 22, which limits the ability of the state to alter the allocation of property tax revenues. In particular, Section 25.5(a)(7) provides that the legislature may not enact a statute that would require a redevelopment agency "to pay, remit, loan or otherwise transfer, directly or indirectly, taxes on ad valorem real property and tangible personal property allocated to the agency...." The voters passed Proposition 22 after former Governor Arnold Schwarzenegger signed into law legislation transferring approximately $2 billion from redevelopment agencies to the state over a two-year period.[1]

The California Supreme Court ruled that AB 26 did not violate Section 25.5 of Article XIII of the California Constitution, because the state legislature has plenary legislative power to abolish redevelopment agencies, just as the legislature had the power to create redevelopment agencies. Further, the court ruled that AB 26 did not violate Article XIII of the California Constitution, because it is not requiring redevelopment agencies to make payments to the state (which would be unconstitutional and violate Proposition 22); instead, the purpose of AB 26 was to abolish redevelopment agencies.

However, with respect to AB 27, the court held that AB 27 violated the California Constitution because it did require redevelopment agencies to make payments to the state. The court found that, while the text of Article XIII of the

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California Constitution does not provide a limitation on required transfers to the state, Proposition 22 was enacted specifically to prevent the state from requiring fund transfers from redevelopment agencies. Accordingly, the court invalidated AB 27, despite the fact that redevelopment agencies could choose to dissolve rather than making payments to the state.

The California Supreme Court determined that AB 27 could be invalidated without also invalidating AB 26, even though the two bills were passed by the legislature as part of a cohesive legislative scheme. AB 27 included a limited severability clause, and the court determined that functionally AB 26 could be separated from AB 27. To this end, the court struck limited portions of AB 26 that referred specifically to AB 27.

In making this ruling, the court lifted a stay of implementation of AB 26 that had been in place since August 11, 2011, while the court considered the case. During the stay, several deadlines provided by AB 26 passed; as a result, the court reformatted AB 26 so that all deadlines contained in the statute otherwise occurring before May 1, 2012, would take place four months later than originally scheduled.

Implementation of AB 26: What Happens Next?

Dissolution and Successor Agencies

All redevelopment agencies in California dissolved as of February 1, 2012. AB 26 provides for so-called "successor agencies" to wind down the affairs of the dissolved redevelopment agencies. AB 26 designates the city, county or city and county that authorized the creation of the former redevelopment agency as the successor agency. However, such local governmental body had the option of electing not to become the successor agency, in which case an applicable local agency (defined as "any city, county, city and county or special district in the county of the former redevelopment agency") could elect by resolution to become the successor agency.[2] If no local agency elected to serve as the successor agency, a public body referred to as a "designated local authority," consisting of a three-member governing board, was appointed by the Governor to assume the duties of the successor agency until such time as a local agency elects to take on the role.[3] While most local governmental bodies assumed the role as successor agency, several did elect not to become the successor agency. For example, the Los Angeles City Council opted not to become a successor agency to its redevelopment agency because of the cost associated with continuing to manage the agency during the dissolution.

AB 26 sets forth the obligations and the parameters of authority applicable to successor agencies. Among other obligations imposed on successor agencies, successor agencies must: (i) continue to make payments due for, and perform the obligations required pursuant to, any "enforceable obligation," as such term is defined in AB 26;[4] (ii) remit the unencumbered balance of the redevelopment agency funds to the county auditor-controller of the county in which the redevelopment agency operated for distribution to the taxing entities in accordance with AB 26;[5] and (iii) dispose of the assets and properties held by the redevelopment agency as directed by the oversight board (as described below), which disposal "is to be done expeditiously and in a manner aimed at maximizing value."[6]

Many questions continue to arise as to what is and what is not an "enforceable obligation." In general, AB 26 broadly defines "enforceable obligations," which includes bond indebtedness, loan repayments and any legally binding and enforceable contract or agreement that is not otherwise void, as violating the debt limit or public policy entered into prior to June 29, 2011.[7] In response to certain questions regarding the definition of "enforceable obligations," the California Department of Finance also has published its clarifying answers, including a statement that the California Department of Finance believes that AB 26 provides that "written contracts for specific performance with parties that are not the sponsoring agency are what qualify as enforceable obligations."[8]

California's Post Redevelopment Agency Landscape (continued)

Prior to February 1, 2012, each redevelopment agency was required to adopt a final "Enforceable Obligation Payment Schedule" listing all of the redevelopment agency's enforceable obligations. Successor agencies may only make payments as a result of enforceable obligations listed on the Enforceable Obligation Payment Schedule until a "Recognized Obligation Payment Schedule" becomes operative.[9]

Successor agencies are required to prepare and submit a Recognized Obligation Payment Schedule listing required payments on enforceable obligations due over the next six months for the oversight board's approval. A draft Recognized Obligation Payment Schedule must be prepared by each successor agency by March 1, 2012.[10] After the Recognized Obligation Payment Schedule is reviewed and certified by an external auditor and approved by the oversight board, the schedule must be submitted to the county auditor-controller and both the Controller's office and the Department of Finance.[11] Once the Recognized Obligation Payment Schedule is approved by the oversight board, the Recognized Obligation Payment Schedule replaces the Enforceable Obligation Payment Schedule and provides a conclusive listing of the enforceable financial obligations of the former redevelopment agency.[12]

Oversight Boards

AB 26 creates a seven-member oversight board for each successor agency composed of local officials appointed by different local stakeholders. The oversight board must approve certain actions taken by successor agencies, including the establishment of new repayment terms for outstanding loans under certain circumstances and any continued acceptance of federal or state grants.[13] The oversight board also shall direct the successor agency to: (i) dispose of all assets and properties held by the former redevelopment agency; (ii) cease performance of and terminate all agreements that are not enforceable obligations; (iii) terminate any agreement between the former redevelopment agency and any public entity within the same county that obligated the former redevelopment agency to provide funding for any debt service obligation for the construction or operation of facilities owned or operated by such public entity in any instances where the oversight board finds that early termination would be in the best interests of the taxing entities; and (iv) determine whether any agreements or arrangements of the former redevelopment agency and any private party should be terminated or renegotiated to reduce liabilities and increase net revenues to the taxing entities, and to present such proposals to the oversight board for its approval.[14] The oversight board has the authority to approve any amendments or early termination of such agreements "where it finds that amendments or early termination would be in the best interests of the taxing entities."[15]

The oversight board also shall direct the successor agency to dispose of all assets and properties held by the former redevelopment agency.

Control of Tax Increment Funds

The auditor-controller of the county in which the redevelopment agency operated will create a Redevelopment Property Tax Trust Fund (the Redevelopment Fund) and place in that fund the property tax that would have been allocated to the redevelopment agency. Twice each year, the county auditor-controller will distribute funds from the Redevelopment Fund to the successor agency to be used for payment of the enforceable obligations listed on the Recognized Obligation Payment Schedule that come due over the next six months, as well as funds required to pay administrative expenses. The remaining funds are to be distributed to local agencies and school entities as required by statute. The first distributions from each Redevelopment Fund will occur on May 16, 2012, and June 1, 2012.

The county auditor-controller is required to complete an audit of each dissolved redevelopment agency in the auditor-controller's county prior to July 1, 2012, to determine the assets and liabilities of the redevelopment agencies.

In addition, AB 26 includes what is referred to as the "clawback provision," which provides that the state auditor-controller "shall review the activities of redevelopment agencies in the state to determine whether an asset transfer

California's Post Redevelopment Agency Landscape (continued)

has occurred after January 1, 2011, between the city or county, or city and county that created a redevelopment agency or any other public agency, and the redevelopment agency."[16] If such a transfer did occur and if such asset is not contractually committed to a third party for expenditure or encumbrance, AB 26 provides that, to the extent not prohibited by law, the state audit-controller "shall order the available assets to be returned" to the successor agency.[17] The legislature enacted this provision of AB 26 in an attempt to prevent redevelopment agencies from transferring properties to other entities while AB 26 was under consideration by the legislature and to otherwise preserve the assets of the agencies.

Next Steps—Legislative Responses and Proposals

In the coming months, we expect a flurry of activity on three fronts. First, because proponents of redevelopment pre-AB 26 were unable to undermine AB 26 or pass legislation overturning the court's decision, legislators may endeavor to enact or expand existing programs that allow cities and counties to devote funds to redevelopment projects. This potential legislation could include the enactment of programs allowing cities to use tax increment financing based on project areas of a limited size, the expansion of infrastructure financing districts and/or additional authorizations for public-private partnerships in order to spur development.

Second, the legislature may enact, and the Governor may sign, supplemental legislation to clarify or alter the way in which AB 26 is implemented, including procedural changes and clarifications as implementation issues arise.

Third, we expect various properties to become available for purchase as successor agencies dispose of properties previously held by the former redevelopment agencies, creating opportunities for acquisition.

Pillsbury will continue to monitor changes in California's post redevelopment agency landscape as 2012 promises to bring further changes to the applicable law as well as proposals for new policies and programs.

Endnotes

1 Assembly Bill X4 26 (2009).

2 California Health & Safety Code Section 34173(d)(1)-(2). All Code references are to the California Health & Safety Code.

3 Section 34173(d)(3).

4 Section 34177(a); Section 34167(d).

5 Section 34177(d).

6 Section 34177(e).

7 Section 34171(d).

8 California Department of Finance, Redevelopment Agency Dissolution Under ABX1 26, Frequently Asked Questions, available at http://www.dof.ca.gov/assembly_bills_26-27/documents/RDA%20Web%20Page_%20Non%20Bond%20FAQs_Exhibit4.pdf.

9 Section 34177(a)(1).

10 Section 34177(l)(2).

11 Id.

12 Section 34177(a)(1); 34177(a)(3).

13 Section 34180.

14 Section 34181.

15 Id.

16 Section 34167.5.

17 Id.

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