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Article Highlights

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Understanding the Mindset of the Institutional Real Estate Equity Investor

by Brant K. Maller

One can view the real estate equity universe from opposite ends of the spectrum: The ultimate owners of equity capital sit at one end and the ultimate users of equity capital at the other. The ultimate users typically are the real estate operators that need capital to pursue attractive investment opportunities. The ultimate owners of equity capital have assets to "put to work." Some of these owners will tolerate less risk and need to sit higher in the capital stack (*e.g.*, as mezzanine debt). Others have an even higher risk tolerance; they sit at the bottom of the capital stack, bear the first-loss risk and receive a higher return. Without owners willing to take the first-loss risk, equity capital deals cannot get done. Nonetheless, there is a remarkable lack of understanding by many operators—particularly operators used to raising money from friends and family or fund managers rather than institutional investors—of the thought process by which the owners of capital (particularly institutions) invest.

The Use of External Asset Managers

Operators may try to go straight to the sources of capital and disintermediate fund managers (and their asset management fees and carried interest), seeing the fund managers as nothing more than brokers. After all, saved management fees could be perceived by operators as going straight to their bottom line. This appeal is specious, however, because external managers are integrated into the institutional investment process, particularly that of defined benefit pension plans, and need to be accepted by operators as a cost of doing business. To understand why these managers need to be accepted, one needs to understand the institutional real estate investment mindset.

Any major real estate purchase today requires a significant equity investment. There have been frothy periods (the first half of 2007 leaps to mind) when minimal equity was required for a major real estate acquisition (assume a purchase price of $100 million as "major" for purposes of this article). However, in the current environment there has been a dearth of large portfolio lending, a near evaporation of mortgage financing through the bond markets (*i.e.*, the commercial mortgage backed securities (CMBS) markets) and a general tightening in loan-to-value ratios. As a result, the equity requirement for any major real estate acquisition is greater. In our example, even if an operator could patch together financing for 75% of the total purchase price, that would still call for $25 million of equity capital. Any equity investor would want to see a meaningful equity coinvestment by the operator ($5 million, for instance), which would require the equity investor to put up $20 million. In other words, that investor would need the ability to lock up $20 million indefinitely (presumably, the expectation would be to exit by sale within a decade), yet see lower current return and risk losing the full $20 million. The universe of equity capital providers that are willing or able to accept

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these investment parameters is far more limited than one might think. In all likelihood, an investment of that size would come from institutional owners of capital.

Certainly there are some ultra-high-net-worth individuals who have the wherewithal to make a $20 million investment. However, any individual investor of that size is likely to require diversification. This individual investor might allocate up to 10% of his overall portfolio to real estate as an asset class and no more than 20% of that 10% to any single investment. This investor would need to be a billionaire to make the $20 million investment (*i.e.*, 2% of a billion dollars). There are only so many billionaires, they are scattered throughout the world, there is a multitude of investment opportunities for them to look at and there typically are many gatekeepers between them and any given investment opportunity. Even if an operator could command the undivided attention of a billionaire (or his gatekeeper), the odds are long that the billionaire would choose to make any given investment. Moreover, a billionaire investor can be as contrarian as he pleases in deploying his personal wealth, enabling him to consider and more nimbly pursue a broader range of opportunities and risks than can his institutional counterpart. This attribute can make an individual's money pricier than institutional capital that is allocated to a single asset class and is administered by individuals hired only to invest within that class. Furthermore, an individual need not have a rigid, predictable investment process. He can make up (and change) his mind on a whim, so there is less certainty he will fund. These risks are magnified if the equity investment is cobbled together from a consortium of high-net-worth investors. In that case, any single investor could withdraw from the group or decide his money was the final piece of the total required investment and reprice his investment to the operator's direct detriment.

For these reasons and others, it is far more likely that the ultimate source of first-loss equity in a major real estate investment will come from an institutional investor, and among institutional investors, the most likely source is a public defined benefit pension plan. (The points made in this article relate generally to institutional investors, but the focus of discussion is on public pension plans.)

It is far more likely that the ultimate source of first-loss equity in a major real estate investment will come from an institutional investor, and among institutional investors, the most likely source is a public defined benefit pension plan.

A public defined benefit plan is a rare institutional investor because it can tolerate complete illiquidity, lack of return and loss. It also is ultimately backstopped by the contractual promise of the state, and states cannot directly file for bankruptcy protection. These public pension plans have trillions of dollars of capital to deploy and, in the vast majority of cases, a meaningful allocation for equity real estate (perhaps an allocation target of 5-10% of total assets) and other "alternative investments" (alternative to the traditional asset classes of stocks, bonds, cash and cash equivalents). These reasons are why public pension plan capital is a favored pool of investment capital for the corporate private equity world.

While it may be counterintuitive to think that public pension plans would provide the riskiest capital for real estate projects, the investment math they face compels it. Public pension funds have annual target return rates they must achieve in order to pay the benefits their plans have promised pensioners (often in the range of 8% per annum). They typically allocate most (perhaps 60% or more) of their portfolios to public equities and fixed-income investments, but the return profile for those asset classes has fallen far below the 8% target in recent years (hence the enormous funding gaps reported in the news). As a result, the balance of their portfolio, which is allocated to real estate and other alternative asset classes, needs to achieve a high-teens to low-20% internal rate of return, which is a first-loss real estate equity rate of return.

Understanding the Mindset of the Institutional Real Estate Equity Investor (continued)

Once an operator decides to access institutional capital, its first instinct may be to try to partner with a single institutional investor, particularly if the operator has entered into a joint venture with a fund manager in the past. That option often is not available, however, for one main reason: staffing constraints. Hard as it may be for an operator to fathom, a single investment staff member at an institution may oversee the investment of a billion dollars or more of real estate equity capital. That individual simply cannot track all of the details of projects in her portfolio and make timely day-to-day decisions about how best to run those projects. The staffing problem is magnified in the public-pension-fund setting because of the political pressures to keep staff lean. These pressures prevent plans from building up an internal investment function. There are select models for direct investing by public pension plans (*e.g.*, some of the Canadian plans do it, and South Carolina recently announced an intention to ramp up internal staff to invest directly in private equity deals), but the vast majority of public pension plans are too thinly staffed (and, as they would be the first to point out, too poorly paid) to compete with the private sector effectively.

> *Another complicating factor for public-pension-plan investing is that public pension plans typically are subject to public scrutiny and face "headline risk" from the press.*

Typically, the only efficient way for a public pension plan with a small internal staff to deploy a large amount of capital is for it to allocate its capital among a diversified set of asset classes pursuant to an overall asset allocation (regularly rebalanced) and then to allocate its capital further within a given asset class pursuant to a strategic plan to best-in-class external asset managers. There is an ongoing debate about whether it is better to make fewer concentrated bets by allocating more capital to a smaller number of top-performing managers or to allocate less to more managers (the concern being that performance can regress to the mean with too many small managers). Investment staff often work hand-in-hand with investment consultants (and in real estate, there are only a few dominant players) to select managers that implement their strategic plans. Managers tend to be sorted out by return characteristics (in ascending order of risk/reward: core, core plus, value-added and opportunistic).

In this process, the investment consultants are the "gatekeepers." They meet with the hundreds of credible institutional managers, perform due diligence and, when called upon, recommend new managers to investors. These consultants also diligence and monitor existing managers, especially when the managers seek a re-up for a new fund or a coinvestment opportunity. In addition, they often make recommendations that plans' staffs and boards (particularly at smaller plans) tend to follow. Almost without exception, a manager will not raise a commingled fund from public pension plan investors unless it has received the approval of the investment consultant/gatekeeper, and it is unlikely a specific investment would be made over the objection of a plan's consultant.

The plan's investment staff may have delegated authority from its board to allocate capital to external managers. This scenario is particularly true when an investment of less than a certain size or a re-up to a follow-on fund from the same asset manager is involved. Once again, the issue of staffing constraints is likely to affect the decision-making process. Due diligence of a new manager is an arduous process. If a manager's investment performance is good and the manager has behaved like a good partner, it is quite likely that a plan will seek to re-up with the known quantity rather than trying to diligence new funds.

So, while it may seem most economically rational for public plans to invest directly in projects or to act as capital partners with operators, that is just not realistic because of staffing constraints. The challenge is for plans to achieve risk-adjusted after-fee returns from their real estate managers that meet their investment objectives, which, as noted, can be quite high.

Understanding the Mindset of the Institutional Real Estate Equity Investor (continued)

Another complicating factor for public-pension-plan investing is that public pension plans typically are subject to public scrutiny and face “headline risk” from the press. In just about all public plans, there is some involvement by elected officials (*e.g.*, a governor may appoint members of the board and a state treasurer may sit on the board). These public officials often do not think beyond their next elections, while investment staff is thinking about a theoretically infinite (or certainly a 40-year) investment horizon. The difference in investment perspective leads to a natural tension between staff and elected board members. Union representatives on boards also are sensitive to headline risks because they will have to answer to member pensioners who read the newspapers or watch the evening news.

The conclusion that most investment staff and consultants reach is that the best approach is for them to select a diversified pool of top-performing external managers pursuing the best investment opportunities across geographies and property classes over a predetermined (usually three-year) investment period. Managers are given an additional number of years (perhaps six or more) to work and to harvest those investments.

Investment Structure

The most common real estate fund structure follows the private equity model. It involves numerous investors subscribing for limited partnership interests in a single limited partnership, with an affiliate of the investment manager acting as the sole general partner. Subject to very broad parameters, the general partner typically will have discretion to invest the fund’s capital, which it will call from the limited partners (often public pension plans) as opportunities arise. To take into account the lag time for a capital call, the general partner often will use bank subscription lines to tie up assets and create pipelines. If a public pension plan wants to take a somewhat more active role or to tailor more closely the investments to its objectives, then it can set up a separate account with an investment manager or structure a joint venture with a few like-minded investors and a manager. Some larger investors also strike programmatic joint ventures between themselves and operators, but those are less common, and in order to mitigate the headline risk, the joint venturer might be a large, publicly traded entity. Another investment vehicle that has gained prominence is the coinvestment structure, which is a hybrid between a partnership and a joint venture. A coinvestment may have a favorable fee structure, make efficient use of staff and give the investor some comfort that it is investing alongside other investors that have diligenced the opportunity and believe in the investment.

Current State of the Market

At the moment, there still is a lot of institutional “dry powder” in the hands of fund managers. That is because, until the CMBS markets seized in mid-2007, managers were returning capital very rapidly, and appreciative investors were achieving outsized returns. The repaid capital often sat in cash or other short-term investments until reinvested. This repaid capital dragged down the portfolios’ overall returns, but plans’ investment staffs could not be ramped up fast enough to redeploy the returned capital. Target allocations were not being hit in an asset class with superior performance. Two of the key drivers of high-yield investing—capitalization rate compression (at the time at a 20-year low) and ready availability of cheap and deep debt—were present. Managers quickly came back to market with new funds that were ever larger. Ironically, fee structures and terms often grew larger or remained constant (on a percentage basis) as fund sizes grew. During this time, investment staffs committed more capital. Then came mid-2007, and the real estate markets seized and then drifted. Mark-to-market accounting and the financial collapses of 2008 exacerbated the problem, and as a result, real estate became a disfavored asset class among institutional investors.

The 2007 vintage real estate private equity funds often had a three-year “use it or lose it” investment period. Those periods are running out this year. There is anecdotal evidence that a number of savvy investors quietly have been extending the investment period with their favorite managers on terms favorable to investors (*e.g.*, reduced fees). While some managers may feel pressure to deploy capital, the better managers look at investors as “clients” and will reward investor patience with investment discipline.

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There are more than 2,000 different public pension plans in the United States. They are not subject to ERISA (although many instruct their staffs to act as if they are), and they almost all have different rules. With that many plans investing, there are bound to be some at any given time that will invest directly. However, the much greater likelihood is that, for the reasons discussed above, public pension funds will continue to invest primarily through top-performing fund managers, target high returns and remain committed to the real estate asset class and see it as a diversifier, a generator of current cash returns with upside potential and an inflation hedge. There should be fewer managers, because the overall pie has shrunk and real estate has not yet regained favor (although the trend may be turning positive for the first time in a very long time).

The big question is timing. As special servicers and loan officers regain confidence that first mortgages in their portfolios have full value, they will have every incentive to cease to "extend and pretend" (especially regarding the hundreds of billions of dollars of CMBS that are maturing over the next few years) and will start to foreclose. Once they do so, values will reset based upon new pricing. The reset in pricing, in turn, should create investment opportunities and reopen the spigot of institutional capital. In an era of fiscal austerity and pressure to reduce the size of government at the state and local level, capital is likely to flow most easily and quickly through existing external asset managers. Rather than trying to avoid those managers (with, in all likelihood, little success), operators should accept that they are hardwired into the public fund investment process, use them as a source of information and insight into what their investors are thinking and price them into their pro formas. It is best left to the investors to exert pressure on their managers (especially those at the end of their investment periods) to reduce or restructure fees and to better align interests (*e.g.*, a graduated carried interest structure). The fundamental point is that an operator would do better to achieve the best return possible by "buying right" and working the asset rather than by seeking to buck the system and cut out the middleman.

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Time to Review and Revise Partnership and LLC Agreements?

by Dana Proud Newman

Most real estate projects are held through limited liability companies (LLCs) or limited partnerships for a variety of tax and business reasons. Some LLC and limited partnership agreements are heavily negotiated and sophisticated documents, while others are simple "form" documents with minimal customization. In either case, however, these agreements often contain provisions that may produce unintended and adverse consequences to one or more of the parties, particularly if the entity holds a financially troubled project.

Many such LLCs and limited partnerships are in the process of restructuring, which creates the opportunity for parties to review organizational documents to determine if they raise any issues and, if so, to negotiate appropriate revisions. Given that some of these issues may be contentious, they may be difficult to address except in a broader restructuring context.

This article considers some of the key issues that should be evaluated by parties to any LLC or limited partnership that owns a financially troubled real estate project. For simplicity, the article refers to "partnerships" and "partnership agreements," but these references are intended to encompass LLCs and LLC agreements as well.

What Happens to the Parties if the Losses Are Real?

Historically, real estate investment transactions have been structured under the basic assumption that real estate projects will increase in value over time. Depreciation has been regarded as a "paper" loss that may be valuable for tax purposes but will not impact the ultimate cash economics to the parties. Coupled with this basic assumption is the fact that the "tax provisions" in a partnership agreement are frequently quite complex and, many would say, incomprehensible. As a result, developers and investors often focus their business review primarily on the cash flow provisions and leave the tax provisions to the lawyers. These tax provisions may produce unintended economic results, however, if a real estate project goes down in value and the tax losses turn out to be real instead of transitory.

Do the capital accounts determine the share of assets on liquidation? Most partnership agreements provide that a capital account will be maintained for each partner. Usually, such capital account provisions are based in large part on complex tax regulations, but they basically provide that a partner's capital account will reflect the partner's capital contributions, allocation of profits and losses, and distributions of cash. If followed completely, these tax regulations require that on liquidation, a partnership will distribute assets to the partners based on their final capital account balances. As a result, the profit and loss allocations to the partners will determine each partner's ultimate share of the partnership's assets on liquidation. Unfortunately, the profit and loss allocations provisions are often drafted to assume a significant gain on sale. The final capital account balances may be distorted in a loss scenario, producing unintended economic results to the partners.

Are any of the partners obligated to eliminate negative capital accounts? One way in which a partnership agreement may satisfy the tax regulations is to contain a provision that requires a partner with a negative capital account at liquidation to make an additional capital contribution to the partnership in the amount of the negative capital account to reduce it to zero. Partnership agreements which are not negotiated will often include this language, perhaps in reliance on the assumption that gain on the sale of the real estate project will eliminate any negative capital account. However, if that gain does not materialize, the requirement for a partner to contribute after-tax dollars to eliminate a negative capital account will be an economic disaster for that partner. For new deals, or the restructuring of existing ones, the parties should consider whether alternative approaches are available, such as recognizing discharge of indebtedness income.

Are there disproportionate additional capital provisions? If, as part of a restructuring, a partnership requires additional funds, many partnership agreements provide for optional or mandatory disproportionate additional capital contributions by the partners. Often such an additional capital contribution will result in the application of a penalty dilution formula to adjust the percentage interests of the partners. If the partnership continues to incur losses, the adjusted percentage interests, if applied to losses, will result in a disproportionately large allocation of losses to the contributing partner. This has the potential for negatively affecting the contributing partner's share of assets on liquidation (as discussed above).

What Happens if a Partner Exercises Its Transfer or Removal Rights?

Almost all partnership agreements include a provision governing a partner's right to transfer its interests in the partnership, although the scope of limitations and restrictions varies significantly. In addition, many partnership agreements include a provision authorizing the removal of a partner for a breach of the partnership agreement. These terms often are invoked in connection with the restructuring of a partnership that owns a financially troubled real estate project.

Invoking a transfer or removal right may cause a tax termination of a partnership.

Invoking a transfer or removal right may cause a tax termination of a partnership. A partnership will terminate for tax purposes if (a) 50% or more of the capital and profits interests in the partnership are transferred within a 12-month period of time or (b) the partnership has only one partner at any time. A tax termination for a partnership holding a real estate project may have a variety of economic consequences to the partnership and the partners, many of them potentially adverse. For example, it will change the depreciation schedule for the partnership's real estate assets and require a short-year tax return for the partnership. Also, in California as well as other states, a tax termination may result in a property tax reassessment of the real estate project and the imposition of a documentary transfer tax on the real estate project. In some circumstances, it may be possible to achieve the same restructuring while avoiding a tax termination if the terms of the partnership agreement provide sufficient flexibility.

Limited partnership agreements also may prohibit transfers of partial partnership interests. However, although these provisions may appear to be neutral, they may not be in application. If a partnership agreement gives partners certain transfer rights, but limits the right of a partner to transfer its partnership interest if it will cause a tax termination while at the same time limiting the right of a partner to transfer less than all of its interest, then a partner with a 50% or more interest has no effective transfer rights. The transfer rights in an existing partnership agreement should be evaluated to determine whether the partners operationally have equivalent transfer rights.

Partners also should review whether the partnership agreement provides for flexible buy-out and removal rights. Many partnership agreements give a partner (the "electing partner") the right to elect to buy out or remove another

Time to Review and Revise Partnership and LLC Agreements? (continued)

partner under certain circumstances, including a default situation. However, electing to exercise such buy-out or removal rights may be at a cost to the electing partner if it triggers a tax termination, either because (a) it results in a transfer of 50% or more of a capital and profits interest, or (b) the partnership has only two partners, and the buy-out or removal will result in a partnership with a single partner.

The tax termination rules are not triggered by a partnership's redemption of a partnership interest or issuance of an additional partnership interest. Therefore, a tax termination resulting from a transfer of 50% or more of a capital and profits interest may be avoided if the partnership agreement permits the electing partner to cause the partnership to acquire a portion of the partnership interest, so that less than a 50% partnership interest is transferred to the electing partner. While such an outcome generally could be negotiated in a friendly transaction, in a default context it may be necessary to have specific contractual rights to proceed in this manner.

Similarly, if the partnership has only two partners, the partnership agreement should give the electing partner the express right to have an affiliate acquire the partnership interest to avoid a single-partner partnership.

Is the Partnership Agreement Up to Date With the Law?

The laws with respect to partnerships and LLCs continue to evolve. For example, in California, the limited partnership laws were restated entirely in 1983 and again in 2008, in addition to numerous amendments in the interim between the restatements. Older partnership agreements should be evaluated in light of current laws to determine if any modifications or additions are necessary. In certain cases, the new laws may impose changes on negotiated terms in the existing partnership agreement without the action of the partners. In other cases, silence in a partnership agreement may result in the statutory provisions controlling.

Some of the new provisions may be of particular relevance to the restructuring of a partnership that owns a troubled real estate project. For example, most states now permit partnerships to merge with another entity or to convert into another type of entity. These merger and conversion rights did not exist 10 or 15 years ago. Therefore, an older partnership agreement that addresses the rights of the general partner and the limited partner with respect to the sale of assets or liquidation may contain no reference to merger and conversion rights, leaving it to the statute to determine the powers of the general partners and the consent rights of the limited partners with respect to such actions. This result may allocate power among the partners in a manner that was not intended.

A limited partnership agreement drafted when real estate values were on the rise or under old laws may result in unintended and adverse consequences for the parties in today's real estate environment. Parties evaluating their options with respect to a troubled real estate project should make sure to include a complete evaluation of the limited partnership agreement to determine if revisions are necessary to protect against these potential consequences.

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BART: On the Right Track With Transit-Oriented Development

by Laura E. Hannusch and Christina Cole

On October 2, 2010, the San Francisco Bay Area Rapid Transit District (BART), Pleasant Hill Transit Village Associates, LLC, Contra Costa County and the Contra Costa County Redevelopment Agency celebrated the grand opening of Phase 1 of the Avalon Walnut Creek at Contra Costa Centre (the Avalon Transit Village), the newest transit-oriented development (TOD) in the BART system. Located adjacent to the Pleasant Hill/Contra Costa Centre BART Station in Walnut Creek (just east of Oakland), the Avalon Transit Village is a mixed-use development that will be completed in two phases. Phase 1 consists of 422 residential apartments (20% of which are reserved for affordable housing) and 35,590 square feet of retail. Phase 2 will contain a 290,000-square-foot office building and 100 for-sale townhomes.

The Avalon Transit Village exemplifies the benefits of a mixed-use community centered around public transit. The 1,477-space surface parking lot that had occupied most of the project's land and served only BART patrons has been replaced with an above-ground garage on a smaller footprint and containing approximately 1,550 spaces, allowing the remaining land to be put to a higher and better use—in this case, housing, retail and office space.

The development will provide an additional revenue stream to BART and put transit property back on the tax rolls. It also will increase BART ridership and allow Avalon Transit Village's residents to have easy access to transportation, which is important for people who cannot afford to own, maintain and insure a private vehicle. Residents also will enjoy the benefits of the vibrant Avalon Transit Village, including the varied retail options as well as the town square with its misting fountain and other public amenities.

BART and the redevelopment agency worked hand-in-hand with the developer to bring the Avalon Transit Village to life. BART contributed the land via a joint powers agency; the redevelopment agency financed the BART parking structure and backbone infrastructure and improvements; and the developer contributed equity and development expertise and assumed debt obligations relating to the development.

A Legislative Priority

The Avalon Transit Village advances BART's TOD policy, which itself is part of a statewide effort to ease traffic congestion, improve air quality and reduce commuting times. The primary vehicle to promote the growth of attractive residential developments around new and existing transit hubs has been the Transit Village Development Planning Act of 1994.

The act encourages cities and counties to promote TODs that are designed for convenient and attractive access to public transit by pedestrians and bicyclists, provide a mix of housing types located no farther than one-quarter mile from the transit station, and include supporting uses, such as retail stores, day care centers, libraries and other civic uses. Projects receiving support of counties or cities must offer at least five of the major TOD benefits articulated by the Legislature, which include: relief of traffic congestion; improved air quality; the "promotion of a safe, attractive, BART: On The Right Track With Transit-Oriented Development (continued)

pedestrian-friendly environment around transit stations"; reducing non-work-related travel by providing goods and services for sale at or near the transit station; increased sales and property tax revenue; redevelopment of depressed and marginal inner-city neighborhoods; and increased stock of affordable housing.

In 2005, BART adopted its own TOD Policy and Program to promote growth and enhance the quality of life around its transit stations, which was intended to encourage development of both BART-owned and adjacent privately owned property. The TOD policy was a natural outgrowth of earlier policies encouraging "joint development," which focused on the development of BART-owned property only. BART recognized that TOD increases ridership, generates new revenues for transit, improves security through increased activity and creates a sense of place for the residents. In addition, local communities, which BART brings into the process from the beginning, benefit from TOD through easier access to public transit, newer retail options, increased property and sales tax revenue and higher property values.

Other Completed BART TOD Projects

The Avalon Transit Village is just one existing TOD project in which BART is involved. These projects, and BART's role in them, are as varied as the communities they serve. Among these are three examples that have improved the quality of life in the San Francisco Bay Area.

BART recognized that TOD increases ridership, generates new revenues for transit, improves security through increased activity and creates a sense of place for the residents.

Strobridge Court in Castro Valley, BART's first TOD project, is an affordable housing development with 96 residential units, 64 of which are reserved for seniors. This project won the 1998 Metropolitan Transportation Commission's Grand Award and the Pacific Coast Builders Conference Gold Nugget "Best of the West" award. This collaborative effort among BART, Alameda County and Bridge Housing Corporation also included the rehabilitation of the historic Strobridge House, which now hosts a community room and three of the residential units, and the construction of a 2,500-square-foot BART Zone Command Police Facility.

Oakland's Fruitvale Transit Village transformed a sea of surface parking in a tough urban environment into a vibrant village that provides housing (affordable and market rate), retail and office space and vital services to the local community. These services include a child development facility, a senior center, health care facilities, a charter high school and a branch of Oakland's public library. In addition, a broad pedestrian plaza links the BART Fruitvale Station to the project's central shopping district. The Fruitvale Transit Village resulted from the efforts of the Unity Council (a nonprofit organization serving the area's Latino community), BART and the City of Oakland, which worked together to resolve concerns over the construction of additional parking at BART's Fruitvale Station, and was supported by economic assistance from the Oakland Redevelopment Agency and other public and private funding sources.

BART's cooperation and its TOD focus also helped transform the City of Hayward's downtown, which had been filled with parking lots and struggling businesses, into townhomes, condos, apartments, Hayward's award-winning City Hall and a pedestrian plaza that links the Hayward BART Station to Hayward's Civic Center and Central Business District. The project served as a catalyst to revitalize the city's downtown and brought new employees into the area. BART reconfigured and exchanged land with the City of Hayward so that the project could be developed.

BART: On The Right Track With Transit-Oriented Development (continued)

Looking to the Future

In partnering with local communities and private (both nonprofit and for-profit) developers, BART has made substantial progress toward its TOD goals. But BART is not done with TOD. BART is working with local communities and developers to plan and develop additional TOD projects, including the following:

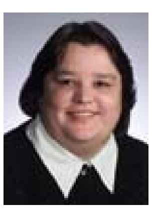
In Dublin and Pleasanton, by partnering with the two cities, the County of Alameda and a private master developer, BART was able to achieve the construction of the new, infill West Dublin/Pleasanton BART Station (expected to be operational in spring 2011) and two new parking garages that would not have been possible otherwise, and the communities ultimately will receive several hundred additional residential units and other transit-oriented improvements.

At BART's Ashby Station in Berkeley, the Ed Roberts Campus (ERC), a nonprofit corporation formed by organizations promoting independent living for people with disabilities, is nearing completion of the construction of a campus that will include approximately 80,000 square feet of office space, along with accessible meeting rooms, a computer/media resource center, fitness facilities and a child development center. ERC selected the Ashby Station for its campus because it affords reliable, accessible public transportation, which is critical for providing mobility for people with disabilities.

There also are plans for TOD at BART's Walnut Creek Station, which will include almost 600 residential units (about 10% of which will be reserved for low-income renters) and office and retail space, along with open spaces and a BART Zone Command Police Facility, and at the MacArthur Station in Oakland, where affordable and market-rate housing and retail/commercial and community space will be constructed adjacent to the station.

Taking Stock

The grand opening of the Avalon Transit Village at the Pleasant Hill/Contra Costa Centre BART Station served as an opportunity for BART to both celebrate its past TOD accomplishments and look forward to numerous other opportunities currently in development and those not yet in the works.



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Construction Risk Allocation and Management: Ten Issues in Construction Contracts

by Scott E. Barat and James P. Bobotek

The success of construction lenders, owners, contractors or subcontractors may depend on how well each of them manages project risks. A major part of risk management is "risk allocation," whereby the parties assign by contract the responsibility for a certain risk to one of the parties that will then bear that risk. The remaining part of risk management concerns how a party manages the risk that is its to bear, so that the possibility (and resulting cost) of the risk is minimized.

One of the most important risk management tools at a party's disposal are the contracts the party will sign with others involved in the construction project. Within those contracts, risk is primarily allocated through indemnity and insurance requirement provisions. Managing risks may be handled not only by sound business and construction practices (such as proper preconstruction planning, proven construction means and methods, use of experienced personnel and stringent safety programs), but also by careful contract preparation and review. Set forth below is a brief overview of some of the key risk allocation and risk management concepts to consider when preparing or entering into your next construction contract.

Allocating Risk to the Party That Is in the Best Position to Control That Risk

A fundamental risk management concept is that owners and contractors should anticipate potential project risks and determine whether it is more advantageous to accept responsibility for each risk or to allocate responsibility for that risk to another party. From a risk management perspective, it is important to assign a project risk to the party best able to control and manage it. For example, a project owner will want to allocate the risk that someone is hurt by construction operations to the contractor, which is in the best position to provide a safe work site. A contractor will want to allocate the risk of design errors to the owner, which often holds the contract with the architect and therefore is in a better position to address and minimize these losses. These are the types of risks that a construction contract should address so that the parties know in advance which party is responsible for what risk.

Indemnity Provisions Are an Essential Way to Allocate Risk

An indemnity provision generally requires one party to pay for losses incurred by the other party (and often to defend the other party against claims for such losses) as a result of claims made by third parties. Following up on the risk allocation example set forth above, a construction contract indemnity provision often requires the contractor to indemnify and defend the owner from and against claims for bodily injury and property damage that arise from the negligence of the contractor or one of its subcontractors while performing the work. Another indemnity clause may require the owner to indemnify and defend the contractor from and against claims based on the existence of hazardous materials on the project site over which the contractor has no control.

Backing Up Indemnity Provisions With Insurance

Indemnity provisions included in contracts are only as good as the indemnitor's ability to honor them. The indemnitor must have the financial ability to satisfy its indemnification obligations. Accordingly, when transferring risk through an indemnity provision, it is important to ensure that the transferee (or the indemnitor) has, or is able to procure in a cost-effective manner, insurance coverage sufficient to pay for the assumed indemnity obligations. One caveat to this general principle is that some risks allocated in an indemnity provision, such as liability arising out of an indemnitor's intentional misconduct, are not insurable due to moral hazard and/or public policy considerations. The lack of insurability for such conduct, however, does not necessarily constitute a valid argument for not requiring the indemnity—the party best able to control the loss should be the one indemnifying the other party from and against that loss, regardless of whether insurance is available to backstop the indemnity.

Insurance Is a Fundamental Way to Manage Risk

If a party has responsibility for a type of loss on a project, it will want to obtain insurance for that loss to minimize its costs should the loss be realized. Accordingly, when preparing insurance requirements for construction-related contracts, it is important to identify and address the risk obligations associated with each project discipline and to make sure that the limits are adequate to address possible losses.

Design Professionals. Contractual insurance requirements for design professionals (*e.g.*, architects, engineers) should include automobile and commercial general liability (CGL), workers' compensation/employers' liability and, most importantly, professional liability insurance. The limits of design professionals' professional liability coverage are particularly important. Because a professional liability policy typically will cover losses arising on all of a design professional's projects, not just your project, it is important that the aggregate limit be sufficiently high. Indeed, owners often consider requiring excess limits for professional liability coverage or that the coverage be "project specific" either through a separate project policy or sublimits applicable only to the project. For large projects, an owner also may wish to consider obtaining owner's protective professional liability insurance coverage, which indemnifies the owner directly for losses arising out of the design professional's professional negligence that exceed the limits available under the design professional's own professional liability policy.

Contractors and Subcontractors. Those contractor and subcontractor entities performing construction work on the project should be required to carry automobile liability, CGL and workers' compensation/employers' liability policies, as well as an excess liability policy providing coverage over the automobile and CGL policies' limits. For those contractors and subcontractors performing any design-build functions, professional liability coverage also should be required. To prevent coverage gaps, contractors' and subcontractors' insurance requirements should include pollution liability coverage. If the owner will procure the property or builder's risk coverage, as discussed below, contractors and subcontractors should consider the need for an "installation floater" or similar coverage to protect their equipment and supplies on-site, off-site and in transit.

Property/Builder's Risk Coverage. While the liability coverage referenced above covers most project accidents resulting in (i) bodily injury and (ii) damage to property other than what is being constructed, in most cases it does not cover damage to the structure being built or the materials being used. This damage, however, may be covered by obtaining a "builder's risk" policy. While it is sometimes possible to cover damage to construction projects under an owner's existing property policy, there are coverage limitations in standard property insurance forms that make procurement of a builder's risk policy desirable in most cases. If a builder's risk policy is procured, consideration should be given to whether the owner or the contractor obtains it. This determination is best made on a project-by-project basis taking into consideration such factors as the type of project (*e.g.*, new construction or renovation of an existing structure), type of contract (cost plus or stipulated sum), financing/lender's requirements (the owner may want to "bundle" soft cost and loss of income coverage with the builder's risk policy to avoid claim delays and arguments among insurers over coverage), the presence of a master property program (owner or contractor), the location of the project, the parties' relative economic leverage to negotiate the most favorable premium and coverage, the contractor's level of sophistication and the owner's desire to participate in project-specific risk management. That being said, it is more common for owners than contractors to purchase builder's risk insurance, which covers the interests of all of the other parties having an interest in the project.

Using Surety Bonds to Manage Risk

The risks of nonperformance and of nonpayment are shared by owners, contractors and subcontractors of all tiers. Both of these risks can affect the timely and on-budget completion of the project. For this reason, owners often require contractors to post a performance bond, which typically obligates the issuer of the bond (known as the "surety") to complete the project if the contractor is terminated, and a payment bond, which typically obligates the surety to make payments due from the contractor to subcontractors if the contractor does not do so. Likewise, contractors will require payment and performance bonds from subcontractors to mitigate the risk of subcontractor nonperformance and failure of subcontractors to pay sub-subcontractors or suppliers. In some instances, contractors will use "subcontractor default insurance" that will reimburse the insured contractor for damages incurred as a result of the subcontractor's failure to perform.

Owners and contractors should require all downstream contractors and/or subcontractors to add the owner and contractor as an additional insured under the downstream parties' liability policies.

Addressing Potential Insurance and Bond Coverage Gaps

As discussed above, many risk management products, including insurance policies and bonds, are required to cover the risks presented by a construction project. Insurance policy provisions are drafted to create in one policy the exact coverage that is excluded by another policy. To the greatest extent possible, the coverage provided by these policies should fit together. It is therefore wise to have an insurance broker and/or attorney review the entire risk management program to identify gaps in coverage and to suggest amendments, endorsements and additional coverage to close these gaps.

Adding Protection by Including Additional Insured Requirements

Owners and contractors should require all downstream contractors and/or subcontractors to add the owner and contractor as an additional insured under the downstream parties' liability policies. Additional insured status adds a layer of protection to an owner's or contractor's indemnity requirements and its own insurance. A key advantage to being an additional insured is that the insurer has an upfront duty to defend claims made against additional insureds, whereas most indemnity provisions require that the indemnitee only provide reimbursement of any defense costs. When drafting additional insured provisions, it often is advisable to include a requirement that the additional insured endorsement be broad enough to cover both ongoing and completed operations, as well as the additional insured's liability arising out of the work, on a primary and non-contributory basis. Be sure, however, not to ask to be named as an "additional named insured," as this may impose undesirable obligations, such as paying a deductible, self-insured retention or premium if the first named insured fails to do so.

Construction Risk Allocation and Management: Ten Issues in Construction Contracts (continued)

Ensuring That Waivers of Subrogation Are in Place

Including waivers of subrogation ensures that many project risks are properly transferred from the contracting parties to their insurers. Basically, such provisions prevent insurers from passing risk back to downstream project parties by precluding insurers from seeking reimbursement from other project participants for amounts paid on claims. Because an insurer "stands in the shoes" of its insured when bringing a subrogation claim, it cannot bring such a claim if its insured has waived this right in its contract with the allegedly culpable party. For this reason, waivers of subrogation ensure that transferred project risk stays with the insurers.

Don't Rely on Certificates of Insurance

Many parties to a construction project fail to adequately confirm that the project insurance requirements have been satisfied, either upon execution of the contract or throughout the duration of the project. Required coverage limits, additional insured status and waivers of subrogation provide no benefit if they were not obtained or are permitted to lapse. Owners and contractors frequently rely on a cursory review of certificates of insurance to "confirm" compliance with insurance requirements. This practice is risky, as many insurance certificates include incorrect and/or incomplete information, such as omitting mention of risk-changing exclusions or endorsements. In addition, most certificates of insurance are prepared using an industry-standard form. Courts have found that these forms are so replete with express disclaimers that they are not legally binding on the party providing them. As such, it is advisable to require in the contract not only delivery of a certificate of insurance evidencing the proper insurance coverage, additional insured status and waiver of subrogation, but also delivery of applicable endorsements (if not the full policies themselves) evidencing such coverage. Performing a diligent review of the information provided will greatly diminish, if not remove, the anguish, costs and lost time suffered upon discovery, after a claim is made, that the coverage identified in the certificate of insurance in fact is not what the actual policies provide and is not what is required under the relevant contract.

Careful Contract Review

Each construction project includes multiple contracts, all of which should be consistent and complementary. For example, dispute resolution provisions should be harmonized so that all parties involved can be in the same proceeding at the same time; this will avoid inconsistent results that may arise if there are several different cases addressing the same issues. Project lenders' and owners' requirements regarding payment timing and limitations should be properly flowed down into all project contracts so that payment provisions are consistent throughout the contracts. In addition, many lenders, owners and contractors use form contracts with insurance and indemnity requirements that are outdated, unenforceable or otherwise unobtainable. Forcing a party to obtain insurance in a form that is no longer offered, or offered only at a cost-prohibitive premium, is not in the project's best interest. To avoid these problems, it is crucial to have an experienced attorney review the contracts. Just as important, there is no substitute for each party reading its contract very carefully before signing. Beyond the obvious problems of errors and inaccurate information that creep into negotiated contracts, careful review may reveal additional risks, improperly allocated risks and other issues that a lawyer, who often is not as familiar with the project as the client, would not catch. Remember always that few agreements are perfect and that vigilant contract review is one of the most crucial steps in the risk management process.

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Mirror World Meets Real World: A Crash Course on Emerging Technologies for Real Estate Owners and Developers

by James G. Gatto and Brad M. Dashoff

The old adage about the three most important factors in real estate may be in trouble. "Location, location, location" may soon be replaced by "location-based services, augmented reality, and mirror worlds" if a new breed of entrepreneurs has its way. These emerging technologies are impacting profoundly how businesses operate and are raising interesting economic, technological and even philosophical issues, as the law tries to keep pace. Whether or not real estate owners and developers are currently using these technologies, there are important legal considerations to be contemplated.

Before exploring some of the legal issues arising from use of these technologies, it is important to have a basic understanding of the technologies involved:

Mirror Worlds are virtual replicas of actual world places, most often replicating actual cities or other locations through which a user can navigate and interact via an avatar. Examples include Twinity and EverScape. The mirror world features certain interactive replicas of real world buildings and businesses that allow users to "enter" the building to explore and patronize the businesses inside.

Augmented Reality represents a view where a real-world environment is augmented by an overlay of text, graphics or multimedia. An example is the iPhone app that uses the iPhone camera, GPS and digital compass to reveal a user's position and orientation, which in turn enables the user to point his phone at a building and see a picture of the building overlaid with facts or data about the building.

Location-Based Services encompass a wide array of services primarily based on knowing one or more users' location to provide real-time data, marketing or other value-added services.

What are the important considerations for each technology?

Mirror Worlds

There are a host of legal and business-related issues to consider with respect to mirror worlds. Some of these issues include deciding whether renting a real world premises includes the tenant's right to use the mirror world premises, controlling uses for mirror world premises, and negotiating rent/revenue sharing for mirror world premises. Others are more unique.

Mirror World Meets Real World: A Crash Course on Emerging Technologies for Real Estate Owners and Developers (continued)

For example, owners of real world buildings may want to:

- Control the presentation and rendering of their properties in mirror worlds
- Control exterior signage, advertising or naming on virtual replicas of their buildings and/or share any revenue derived from such permitted uses[1]
- Control uses of their properties to create interactive buildings in the mirror world (*e.g.*, no commerce or interaction without owners' consent, no seedy depictions, no discriminatory uses)
- Leverage valuable copyright protection for certain aspects of architectural works
- Obtain indemnification from mirror world operators and creators for harm resulting from infringing or other misuse of buildings in mirror worlds
- Consider trademark protection of real world buildings, signs and other marks

Moreover, owners may want to include in real world tenants' leases the rights and responsibilities for the tenants' uses of the mirror world building. Some examples of how the physical world lease and the virtual world issues intersect would include:

- If a tenant pays for exterior signage on a real world building or such signage requires the owner's consent, the same could be negotiated to apply or not apply to the mirror world building.
- If a tenant's real world rent is calculated in part based on the tenant's sales (under a percentage rent provision, for example), and the tenant is generating sales in part from space inside the owner's mirror world building, such sales may be considered either in the real world rent calculation or in a separate mirror world rent/revenue sharing calculation.
- In the event of a real world default by a tenant, a potential remedy could be eviction from the mirror world building.
- An owner may want to require the tenant to keep the real world lease confidential from the mirror world operators/creators and users, except as expressly agreed to by the owner.
- Any other real world lease provisions could apply in the mirror world (*e.g.*, permitted and prohibited uses of the space, subletting the virtual building).

Mirror worlds may provide a forum for planning and modeling real estate projects.

Finally, mirror worlds may provide a realistic forum for planning and modeling real estate projects:

- Owners can collaborate with architects and contractors to construct new buildings and projects within a mirror world to enable local jurisdictional officials, concerned citizens' groups and potential lenders and investors to experience interactively a realistic representation of what the completed project would look like, including how it would affect the surrounding property (*e.g.*, Starwood built a mirror world of its new Aloft hotel brand before building the first actual hotel).

Mirror World Meets Real World: A Crash Course on Emerging Technologies for Real Estate Owners and Developers (continued)

- Brokers can use mirror worlds to preview neighborhoods and show buildings (exterior and/or interior) to potential tenants and buyers, both as a marketing tool and as a time- and cost-savings tool, and can also depict various customized build-outs and finishes to fit the particular tenant's or buyer's needs and enable a virtual walk-through.

Augmented Reality

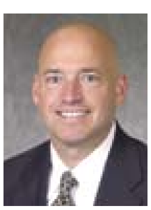
Some of the legal issues that arise with respect to augmented reality include a user's right to privacy with respect to its location, the use of third-party data sources and potential liability if overlaid data is inaccurate. For example, a building owner may not want non-public information about its building or the tenants in the building to be included by a third-party provider of such data for use in an iPhone app unless the owner receives a licensing fee for the use of such information and/or an indemnification from the third-party provider for the dissemination of incorrect information about the building.

Location-Based Services

Implementation of location-based services to leverage knowledge of individuals' or groups' locations enables a wide array of interesting business models, including notifications to users of when others in their social network are near the same location. Owners and operators of property primarily used for retail or entertainment purposes may be interested in using location-based services to track the preferences of visitors to the property and provide real-time location-based coupons or other incentives. These uses provide valuable information to property and business owners but can raise concerns about privacy issues, owners' rights to monitor visitors to their properties and the legality of certain behavioral targeting techniques.

Conclusion

This article has described just a few simple examples of the litany of uses and legal issues that may arise with virtual worlds, augmented reality and location-based services. As these exciting emerging technologies continue to evolve, and as businesses continue to integrate them into their daily operations, it is becoming imperative for property owners and their decision-makers to have a sufficient understanding of owners' legal rights and responsibilities in order to maximize financial opportunities and minimize liabilities from the use of these technologies.



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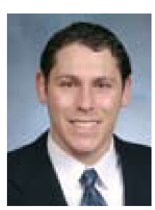

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Endnote

[1] *See, e.g., Sherwood 48 Associates v. Sony Corp.*, 76 Fed.Appx. 389, 2003 U.S.App.LEXIS 20106 (2nd Cir. 2003), involving digital alteration of real world Times Square billboards. In *Sherwood*, the owners of buildings in Times Square brought claims based on a scene from the movie *Spider-Man* in which advertising was digitally superimposed on the owners' buildings appearing in the re-created version of Times Square in the movie. One of the claims brought by the building owners was that the alteration of the buildings constituted a trespass, which they argued could occur as the result of the diminution of value of one's property without physically damaging such property. This claim was dismissed for procedural reasons, but other cases have found "the deprived use of personal property" does constitute a "digital" trespass. *See, e.g., eBay, Inc. v. Bidder's Edge, Inc.*, 100 F. Supp 2d 1058 (N.D. Cal. 2000) (likening the repeated access of another's computer resources "to unlawful trespass").

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