SEYFARTH SHAW

Property Lines

A Publication of Seyfarth Shaw LLP's Real Estate Department

A Message From Paul Mattingly, Chair of Seyfarth's Real Estate Department

Welcome to the inaugural edition of *Property Lines*. Our Firm exists to serve our clients. As a real estate department we are working to respond to client feedback asking for proactive discussions of those issues that are, or will soon be, impacting their businesses. We hope *Property Lines* provides something of value for each of you.

We want to thank Bob Dougherty with Buchanan Street Partners for kicking off our voice of the client segment - "Market Mindset". We think you will enjoy his perspective as much as we have. We view actively listening to our clients as the most important key to our success.

Please reach out to your Seyfarth relationship partner, the authors of any of our articles, or me with any questions, comments or article ideas. Feel free to peruse this newsletter or for ease of navigation, please click on an article below and the link will take you directly to the article.

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Peter J. Korda

About Seyfarth Shaw LLP's Real Estate Department

Seyfarth Shaw LLP's real estate department combines extraordinary depth with a truly national footprint. Comprised of four national practice groups - Finance, Institutional Investment, Leasing and Development - Seyfarth fields one of the country's largest and most comprehensive real estate departments. We have over 120 commercial real estate attorneys distributed across our 11 domestic offices. Our team is supported by other Seyfarth colleagues with deep expertise in tax, bankruptcy, construction, environmental, zoning, bond and municipal finance, securities and REIT issues. This depth permits us to provide national coverage with local expertise. Our depth also permits us to invest in technological innovation that is enhancing the manner in which we communicate and share work product with our clients. We are proud to be assisting our clients in achieving their goals across a broad spectrum of real estate activities, including closing some of real estate's most notable transactions and helping structure a number of our clients' key initiatives.

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To be added to the Real Estate mailing list, please send an email request to: *seyfarthshaw@seyfarth.com*.

Market Mindset

An Interview with Bob Dougherty of Buchanan Street Partners

"We're focused on markets where fundamentals have not returned to peak levels."

Seyfarth Shaw's Steven Fein sat down with Robert (Bob) Dougherty, a Partner at Buchanan Street Partners, to understand how Bob views the current state of the real estate market and why certain markets fit into Buchanan's long-term strategy more than others.

Steve: Where do you see the real estate market going in 2014?

Bob: While the U.S. economy is not at its peak, it is far better than the economies in the rest of the world. Consequently, we continue to see a flood of capital into commercial real estate because it has a risk-adjusted return which compares favorably to other asset classes domestically and to investment elsewhere in the world. With compressed Treasury rates and tightened mortgage spreads, we're seeing the value of commercial property propped up. We've seen debt spreads come in 50-75 basis points in the last 12 months, and a significant rise in conduits - the MBA reported more than 35 conduit shops seeking to originate new loans - so the number of people seeking to originate new loans makes for a very competitive, borrower-friendly environment.

We see real estate returns remaining relatively low because of the supply of capital and property values remaining high. We feel that some of the property values are artificially inflated by debt, particularly core assets which face devaluation risk when interest rates eventually rise.

Steve: How has the current environment impacted Buchanan's investment strategy?

Bob: Post-recession our focus has been on equity investments in Texas and markets in the West, such as Denver and Houston. To buy an office building in San Francisco for $800 a square foot at a 4% cap that is propped up by 2.5% debt is a difficult proposition for us. Our focus is on fundamental value against replacement cost. For example, we would rather buy a suburban office building in Denver for $130 a square foot that would cost $225 to replace, and where we could go in at a 6.5% cap.

Steve: For groups like Buchanan, why are suburban markets an attractive investment?

Bob: Buchanan is focused on markets where rent levels haven't returned to peak. If you look at Silicon Valley and areas of Houston, rents are at or through their all-time highs. Buchanan is more focused on markets like Phoenix or Denver where rent is still 20-25% off peak. Within our desired markets, we try to isolate suburban versus urban. There are urban areas in Denver, for example, where purchase prices are pushing $500 a square foot versus a suburban property that you can purchase for $150-200 per square foot.

Steve: It appears that multi-family has picked up and retail has slowed down. Is Buchanan seeing the same trend?

Bob: The big question in retail remains "what is the future of the bricks and mortar store?" Big box retailers are shrinking their footprint almost without exceptions and retail is generally trending more towards the entertainment component - the restaurants, the cinemas, the gyms - but with that comes a big credit question.

Steve: When you are doing an analysis of property, do you consider long-term impacts? For example, in 10 years people may no longer go to the movies because they can live stream on their devices. How does the millennium generation factor into Buchanan's considerations for what you underwrite?

Bob: We are very tuned into those trends. However, being opportunistic and value-add investors, we like to underwrite 2-3 year business plans, leaving a little less time for those macro trends to play out. Certainly we always have an eye towards the future. I think urbanization, for example, is a growing trend because the millennial generation seems to favor that lifestyle. Another huge factor is the increasing sensitivity of the carbon footprint and the value placed on more compressed living, more mass transit orientation or a pedestrian lifestyle. These trends are inevitable.

Steve: Equity, preferred and mezzanine equity transactions have remained relatively flat. Do you think there will be a significant increase in these types of transactions?

Bob: With regard to mezz debt and preferred equity, the biggest factor is that most of the groups that historically would have employed these financing vehicles have so much money that they just don't want the smaller slice. They have billions of dollars to invest and, rather than giving someone a 12% yield in that middle tranche and leverage their own return up to 20%, they prefer 15% across the whole piece. For them, putting assets under management is the preferable avenue.

The other trend in terms of equity that I've noticed is that there are fewer joint ventures. One thing that we have heard very distinctly from pension plans is that they are much less favorable to the allocator model. For example, Buchanan giving money to a local operator is less in favor because of the fee load. Instead, institutional investors prefer to invest with vertically integrated operators that own and operate product directly to avoid a double load. The trend isn't likely to change and is dictated by capital as much as anything.

In the trend towards the disappearance of joint venture equity and partnerships, one of the factors we've noticed is that in many cases the capital provider during the downturn had to step in to cure issues and ultimately operate many of these properties. So they hired staff that have that capability and developed more in-house acumen in owning and operating properties. For them, the value proposition that the local operator provided wasn't as important as they had previously thought, which led to a "do it ourselves" mentality.

Steve: It seems that we may be in a rising interest rate environment. Is Buchanan experiencing the same trend?

Bob: Honestly, I think the rising interest rate trend was a blip. There was a tick up in early February, but that's been more than erased over the last 30 to 45 days. Interest rates are near all-time lows across the board from our perspective. We all know that rising rates are inevitable - they can't stay as low as they are now - but Buchanan doesn't believe that's imminent. The fundamentals of the global economy are challenged, but I'm learning increasingly that you can't look at the U.S. economy in isolation. While our economy might not feel particularly robust to us, it's better than many other places and still a safe haven for capital.

Steve: Are you starting to see signs of pre-2008 behavior? Are underwriting standards loosening up?

Bob: I don't see recklessness and am still seeing people being fairly disciplined in underwriting. Rates are extraordinarily low and people are willing to accept low yields. But only for very safe positions. Generally I'm not seeing aggressive or reckless plays. People still remember licking their wounds and are keeping LTV's pretty low.

Covenants are still very stringent. Cash management is still strict. If we look at a deal we recently closed, one of the biggest negotiations came down to financial covenants.

The real eye openers that I see pushing the envelope on valuations are for ultra-core assets. A downtown San Francisco office building trade or multi-family in west Los Angeles may cause you to say, "wow, they paid that much for that?" But, you don't go "wow" at the price of a Phoenix office building or a Dallas office building - those prices are still pretty sane.

About Buchanan Street Partners

Buchanan Street Partners is a Newport Beach-based real estate investment management company with roughly $1.4 billion in investments nationwide. Buchanan has four primary lines of business - institutional debt, private debt, institutional equity, and private equity. Buchanan's direct ownership, joint ventures and investment in commingled funds are focused on institutional quality assets ranging in size from $30 to $80 million. On the private debt and private equity side, Buchanan helps high net worth individuals invest in properties ranging from $5 to $20 million.

About Robert Dougherty

Mr. Dougherty is a partner at Buchanan and has been with Buchanan for 10 years. He is responsible for sourcing institutional debt and equity investments and is the portfolio manager for several institutional accounts. He is a member of the Buchanan Investment Committee and is integral in the incubation of new funds and investment programs. He has 24 years of commercial real estate experience including 10 years with CarrAmerica Realty Corporation and has an extensive background in acquisitions, financing, and asset management. He holds a B.S. in Commerce from the McIntire School at the University of Virginia. ■

Seyfarth News

Seyfarth Represents D.R. Horton in $210 million Real Estate Acquisition of Crown Communities

Seyfarth advised D.R. Horton, the largest U.S. residential homebuilder, in connection with its $210 million real estate acquisition of Crown Communities, the largest residential builder in Atlanta and the 28th largest homebuilder in the country. The deal involved a sales order backlog of approximately 420 homes sold, 640 homes in inventory and 2,350 lots. D.R. Horton also acquired control of approximately 3,400 lots through option contracts.

Seyfarth Represents Bank of America in Washington Business Journal's Best Real Estate Deal of 2013: Financing

Seyfarth advised Bank of America NA as co-lender in a syndicated loan to The JBG Cos. in connection with its Fort Totten Square development in Northeast D.C. The development was recognized by *Washington Business Journal* as winner of Best Real Estate Deal of 2013: Financing. JBG broke ground on the $127 million mixed-use project in January 2013. Wal-Mart signed a lease for nearly 120,000 square feet with JBG in August 2012 to anchor the 345-unit residential-and-retail development, kick-starting a project that had been in the works since 2008.

Seyfarth Expands Real Estate Department in Houston

In March, Seyfarth announced that highly regarded real estate partner Peter M. Oxman joined the firm's Houston office. The addition of Peter marks the continued expansion of the firm's over 120-lawyer national Real Estate Department, recognized as the fourth largest real estate practice in the country. "Peter is a well-recognized figure in the Houston real estate community, and a great fit for us as we aggressively grow our Real Estate practice in Texas," said Mark Coffin, managing partner of Seyfarth's Houston office. "Beyond expanding our on-the-ground skillset in Houston, his experience representing real estate and energy industry clients in national projects, as well as cross-border and international projects, will also be a great catalyst for the firm here."

Seyfarth Represents HAP Investments LLC in $400 million Jersey City, 42-Story Building Development

Seyfarth advised HAP Investments LLC in connection with its contract to purchase a site in Jersey City for the development of a 1-million-square-foot mixed-use tower. This the first New Jersey project for HAP Investments and the total investment is expected to be approximately $400 million. Jersey City recently revamped its tax abatement program to provide more tax incentives for developers.

Seyfarth Represents Home Depot in Atlanta Business Chronicle's 2013 Industrial Deal of the Year

Seyfarth Shaw LLP advised Home Depot U.S.A., Inc. in connection with one of its e-commerce fulfillment centers, a 1.1 million-square-foot facility located in Henry County, Georgia. The newly constructed facility was recognized by *Atlanta Business Chronicle* as the 2013 Industrial Deal of the Year. The $45-plus million distribution center was completed in September 2013, with Home Depot officially opening for business in February 2014. The building is expandable to more than 1.3 million square feet and includes more than 23,000 square feet in office space.

Seyfarth Leads Range of Top Deals for Real Estate Industry in 2013

Led by the largest single-property retail transaction and the largest industrial property transaction, Seyfarth handled five of the commercial real estate industry's largest deals of 2013, according to the latest rankings of top deals from *Real Estate Alert*. This marks the second consecutive year Seyfarth handled the largest industrial property transactions.

With a combined value of more than $2 billion, Seyfarth's involvement in the largest transactions of 2013 included:

Large Single-Property Retail Transactions

- No. 1 – Teachers Insurance and Annuity Association of America in the $725 million purchase of a 49.9% interest in the retail portions of the Grand Canal/Palazzo complex in Las Vegas
- No. 18 – Equity One in the purchase of Westwood Complex in Bethesda, Md. for $140 million

Large Industrial-Property Transactions

- No. 1 – DEXUS Property in the sale of West Coast Portfolio to Heitman and Pension Korea for $542 million
- No. 8 – LBA Realty in the sale of LBA Realty Portfolio to AEW Capital for $249 million

Seyfarth Shaw Recognized in Chambers USA 2014 Rankings

The 2014 edition of *Chambers USA*: America's *Leading Lawyers for Business* recently recognized Seyfarth Shaw real estate attorneys in California, Georgia, Illinois, Massachusetts, New York, and Washington, D.C., among the top lawyers in the industry. We are grateful to our clients for their positive feedback, including:

"Their greatest strength is the ability to break down key legal and business issues in a way that business clients can comprehend readily."

"One of the great things they do is back each other up - if my lead attorney is on vacation I always know there's somebody to go to who's been briefed on what we're working on."

"They are creative and outside-the-box thinkers and they put themselves in our shoes in order to effectively accomplish our goals."

"Seyfarth Shaw has the breadth and depth of experience to provide sound advice and excellent execution across a range of real estate and other matters."

Commercial Real Estate News and Analysis

A Buyer's Guide for Preparing a Closing Checklist in a Skilled Nursing Home Property Acquisition

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Below you will find a general checklist to help guide those who are planning to purchase, finance or develop a property on which a skilled nursing facility exists or will be built. This checklist pertains to the purchase of the fee interest and not the transfer of the underlying operations.

The ideal first step prior to acquiring any real estate, including a healthcare related property, is to perform a proper due diligence investigation. The results of a Buyer's investigation should make the Buyer aware of any material facts or issues relevant to the use of the property as a skilled nursing facility or any ancillary uses. Generally, a Seller of commercial real estate will negotiate so that its liability is limited to the representations and warranties that the Seller expressly makes in the signed purchase and sale agreement between the Seller and the Buyer. Accordingly, it is the Buyer's obligation during the due diligence (i.e. inspection) period to conduct examinations and determine whether there are any problematic facts or issues relating to the purchase of the property. Even if the Seller does make a contractual representation and/or warranty about the state of facts at the property, this should not be a substitute for due diligence as such representation or warranty may only provide the Buyer with limited recourse or prove challenging to enforce or to effect collection.

The following non-exhaustive checklist is meant to offer a Buyer general guidance for how to conduct a meaningful due diligence investigation for a property that is intended to be used as a skilled nursing facility. Remember that this checklist was drafted from the Buyer/Borrower's perspective and the scope and focus of any due diligence investigation depends upon the party for whom the investigation is being conducted, as it will vary according to the party's role in the transaction. Also, factors such as where the particular property is located, the intended use of the property, whether that use is for-profit or not-for-profit, as well as other deal specific factors, will dictate what additional due diligence should be conducted.

I. Putting Together the Checklist

The first step in a deal is putting together the closing checklist for the transaction which, in addition to the diligence items, sets forth all of the transaction documents, loan documents, title documents and delivery requirements necessary to close the deal.

A. **The Purchase and Sale Agreement ("PSA")** sets forth the terms on which the property will be conveyed and lists the documents and diligence items that are required to be delivered by the Buyer and by the Seller.

B. **The Loan Commitment and/or Application** sets forth many of the documents and diligence items which will be required for the loan portion of the transaction.

C. **The Closing Checklist** reflects the PSA requirements, the loan application/commitment and subsequent checklist requirements and lists various other document/diligence/delivery requirements. The closing checklist should be continuously updated throughout the course of the transaction and distributed to the client.

II. Acquisition and Property Diligence

In order to create the appropriate list of diligence/delivery requirements, it is important to ask yourself the following questions:

A. What type of property is the Buyer acquiring (vacant land, improved land, semi-improved land, fully improved etc.)? Is there an existing tenant/operator? Are there any other third parties with rights to the property? This section of the checklist will usually request items such as:

1. Certified Rent Roll/Census Report - the items detailed on the rent roll should at least include the following: (a) name of tenant, (b) commencement and expiration dates of the lease and any renewal terms; (c) rent amount and all other sums payable by the tenant(s) or credited to the tenant(s); (d) options to purchase or to extend or renew the term; (e) amount of security deposit; and (f) other security including, for instance, the identity of any guarantor of any lease. Generally the sole tenant on a property operated as skilled nursing facility is the operator of the facility (subject to a triple net lease), although there may be other subleases or licenses in place for related uses (i.e. beauty salons, therapy gyms, etc. located in the facility).
2. Copies of all Lease Agreement(s), Licensing Agreements, and Other Occupancy Agreements which are important factors in the determination of the value of collateral and value determines loan amount. Cash flow from leases (and other sources) is important to the Buyer/Landlord as it pays the debt service and property expenses.

3. Copies of all Management Agreement(s) - Pay particular attention to: (a) term, (b) fees, (c) identify whether the manager is an affiliate of the property owner; and (d) differentiate between "property" management, "asset" management and "leasing" management, and "operations" management.
4. Copies of Service Contracts.
5. Copies of all Certificates of Occupancy.
6. Other Applicable Building Permits.
7. Property Level Financial Statements & Tax Returns.
8. Real Estate Tax Bills.
9. List of Personal Property.

B. Are there any rights being held back or restrictions on the transfer of the property? If so, the Buyer will want to review any written agreements granting or restricting these rights.

C. What is the Buyer's planned use of the property? Is this a permitted use? This is a two-fold question in a skilled nursing home transaction.

1. First, as to the real estate: Is the actual real estate zoned for such use? What are the rules and restrictions? Is there appropriate street access, sufficient utilities, sufficient parking etc.? This section of the checklist will usually contain items such as:

   a. Appraisals.

   b. Market Study.

   c. Survey and Flood Certificates.

   d. Zoning Report/Zoning Letter.

   e. Engineering/Architectural evaluations.

2. Next, as to the Operations: Is the property duly licensed or can it be duly licensed to operate as a nursing home? If the existing operator will continue to operate the nursing home, the items listed below should be in good standing and effect. If the operations are being transferred to a new operator, the Buyer will want to confirm that the new operator has taken the appropriate steps to become duly licensed to operate the nursing home. Please note: even if the operations are not being transferred, depending on the State the property is located in, there may be notification requirements or other requirements in effect by the State licensing agency as to the transfer of the real estate.

This section of the checklist will usually contain items such as:

   a. Standard Form of Residency/Admission Agreement.

   b. Other Applicable Operating Permits.

   c. Copies of all existing State Licenses.

   d. Copies of all Certificates of Need (if applicable).

   e. Medicare and Medicaid Participation Letters and Provider Agreements; as well as any other third party payor information (such as the Veteran's Administration, managed care companies or health maintenance organizations).

   f. Centers for Medicare & Medicaid Services (CMS) Survey Reports (usually last 3 years).

   g. Material Correspondence with Government Programs and/or Payor Intermediaries (re: overpayment/underpayment/billing/coding/etc.).

   h. Copy of Corporate Compliance Program, if any.

   i. Copy of HIPAA Compliance Policy.

   j. Copies of all Healthcare Provider Service Contracts.

   k. Claims Loss History.

   l. To the extent permissible pursuant to applicable law, copies of: (i) resident lists and information regarding Resident Trust Funds, (ii) patient medical records, financial records and employee records relating to the skilled nursing facility, (iii) operating procedure manuals, and (iv) any other material agreements.

D. If there are improvements, what physical condition are they in? Are they structurally sound? This section of the checklist should request items such as:

1. Property Condition Report (including Code Searches).
2. Operations & Maintenance Plan (commonly called an "O & M Plan").
3. Termite Inspection Report.
4. Engineering/Architectural evaluations.
5. Copies of Insurance Certificates:
   a. Property and Casualty,
   b. Evidence of Flood Insurance (if necessary),
   c. General and Professional Liability, and
   d. Worker's Compensation.

E. Is the property environmentally sound? Has there been any previous contamination either on the property or from neighboring properties? Are there underground storage tanks (UST's) or any recognized environmental conditions (REC's)? This section of the checklist will contain items such as:

1. Phase I Environmental Report.
2. Phase II Environmental Report, Geotechnical Report or any other report recommended in the Phase I Environmental Report.

F. Are there any encroachments onto the property, or from the property onto other lands? Any liens or encumbrances on the property that either need to be removed or taken subject to?

The property section of the checklist will usually contain items such as:

1. Title Commitment - The primary title insurance policy forms are known as the American Land Title Association (ALTA) Owners and Lenders Policy forms.
2. Copy of Recorded Documents/Exceptions (e.g. Easement Agreements).
3. Pro-Forma Title Policy with endorsements - An owner's title insurance policy indemnifies the insured against loss or damage incurred by the insured by reason of: (a) title being vested other than as stated in the policy, (b) any defect in or lien or encumbrance on title, (c) unmarketability of title, and (d) lack of right of access.
4. Survey - The survey illustrates the physical relationship between the property, the buildings and improvements on the property and the easements and other matters contained in recorded documents, and may disclose rights or interests in the property not reflected by the public records. A lender will usually require an ALTA survey.
5. Payoff Letter for existing indebtedness (if any).
6. Copies of Mortgage/Other Lien Releases.

G. The parties. As the Buyer you will want to know a little bit about your Seller. Is your Seller an individual or an entity? Do they have the necessary approvals and legal authority to enter into this transaction? Additionally, the Lender will want to know about its Borrower, is it a person or an entity? If it is an entity where are they formed, are they in good standing, are the persons signing on behalf of the entity authorized to bind the entity? This section of the checklist will usually require the following information:

   1. Formation Document (e.g. Articles, Certificate of Formation, Certificate of Limited Partnership).
   2. Governing Agreement (e.g. Bylaws, Operating Agreement, Partnership Agreement).
   3. Incumbency Certificate.
   4. Resolutions which authorize the transaction, the appropriate officers to enter into the transaction on behalf of the entity and ratify any actions already taken with respect to the transaction.
   5. Good Standing Certificate - Generally, if an entity is more than 60 days old, it is likely that the lender and/or the title company will require a Good Standing Certificate from both the state it is formed in and the state in which it does business (if different) stating that the entity is good standing.
   6. Qualification/Authority to Do Business - A Borrower must qualify to do business in the state where the property is located if the different from its state of formation. Note that some states require that managing members or general partners of the property owner also qualify.
   7. Federal Tax I.D. Number (W-9).

H. What documents are required to consummate the transfer of the property? Customary requirements are:

   1. Purchase Agreement.
   2. Deed of Real Property.
   3. Bill of Sale of Personal Property.
   4. Assignment and Assumption of Contracts.
   5. Termination of Existing Lease or Assignment of Existing Lease (each, as necessary).
   6. FIRPTA.
   7. New Lease Agreement (if necessary).
   8. Closing Settlement Statement.
   9. Operations Transfer Agreement (if the operations of the facility are being transferred).

III. Financing Diligence

A. What may your Lender require?

   1. What loan terms have the Borrower and its Lender agreed to? What is the collateral? What type of loan is this? Are there reserve requirements (interest, repair, real estate taxes, insurance)? Is there a Loan Commitment fee or "good faith deposit" due upon the Borrower's acceptance of the Loan Commitment and/or Lender's acceptance of Borrower's application? This section of the Lender's requirements/checklist will list items such as:

      a. Term Sheet.
      b. Loan Agreement.
      c. Mortgage/Deed of Trust.
      d. Promissory Note(s).
      e. Environmental Indemnity Agreement.
      f. Guaranty - which may be full, partial, secured or unsecured payment guaranties, collection guaranties or a variety of other types of guaranties as may be required by Lender.
      g. Construction and Repair Escrow Agreement, Copies of construction manager and other construction agreements, Architect Agreement, Building Permits, Site Plans and Specifications, and other construction documentation (if it is a Construction Loan).
      h. Automatic Payment Authorization.
      i. UCC-1 Financing Statements.
      j. Assignment of Leases and Rents.

k. Subordination and Collateral Assignment of Management Agreement(s).

l. Tenant Estoppel Certificate(s).

m. Subordination and Attornment Agreement.

n. Opinion(s) of Borrower's, Guarantor's, Operator's Counsel.

2. Typically the Lender will also run the following due diligence in at least the state where the entity was formed and any state that the entity does business in (including the state where the property) is located:

   a. UCC, Judgment, Tax Lien, Bankruptcy and Litigation Searches for Borrower, Seller and Tenant.

   b. UCC, Judgment, Tax Lien, Bankruptcy and Litigation Searches for Principal/Guarantor.

IV. Third Party Debt Documents

A. Buyer's mortgage lender will want to see any documents relating to any other financing arrangements of Buyer or of Buyer's tenant (if any). Customary requirements would be copies of loan documents for any:

   1. Accounts receivable financing/credit facility - An operator of a skilled nursing facility will almost always have this type of credit facility in place.
   2. Affiliated financing.
   3. Second Lien financing.
   4. Mezzanine financing.

B. The fee owner's mortgage lender may also require that an Intercreditor Agreement be entered into between the mortgage lender and any other secured party/financing source of Buyer or Buyer's tenant.

V. Conclusion

Conducting the Due Diligence Investigation is important. The contractual "due diligence period" typically provides for an "out" so that the Buyer can walk away from the property and possibly even receive a repayment of some or all of the deposit the Buyer has put down, if a Buyer determines its intended use for the property is not legally possible or financially feasible. The above checklist should provide the Buyer of a proposed skilled nursing home property with a meaningful place to start its investigation; however, every transaction is different and it is important that a Buyer tailor its due diligence review to the facts and circumstances surrounding the specific property and business that will be purchased. ■

Seyfarth Attorneys Assisting Clients to tap "EB-5 Project Capital" from Foreign Investors

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Seyfarth has organized a multi-departmental practice group to assist our clients to tap foreign sources of capital available to certain U.S. businesses under the federal government's EB-5 immigrant investor visa program. The EB-5 program permits foreign citizens who invest $500,000-$1 million in a new, job-creating business to receive conditional permanent resident status (Green Cards) for themselves and their immediate family members. Each investor's investment must create ten jobs. The amount to be invested is $500,000 per investor in Targeted Employment Areas (TEA), defined as either a rural area or an area of high unemployment; for all other investment locations, $1 million per investor is required.

If the investing foreign citizens meet the conditions of the EB-5 program and other criteria, they receive unconditional Green Cards and become lawful permanent residents of the US.

These EB-5 investors are particularly appealing to developers seeking lower-cost capital, for several reasons:

- The investors' main focus is to receive their Green Cards and to bring themselves and their spouses and children to the United States. Thus, they are often less concerned with the rate of return of their investment than other investors.
- They are also concerned with preservation of their principal, which makes real estate-based investments, where much of the investment will be used to acquire hard assets in the form of real property, particularly attractive.
- Under the regulations of U.S. Citizenship and Immigration Services (USCIS), the agency administering the program, the investors cannot be guaranteed a return of principal and the issuer/developer cannot return the capital to the investors until after approval of their petition to remove conditions on their residence status -- typically three to five years from initial investment.

Additional standards, requirements and features of financings under the EB-5 program include:

- Almost all investments are at the $500,000 level as the larger investment size is unattractive. Investments can be made in cash or property or by the issuance of promissory notes secured by assets other than the EB-5 investment itself.
- The funds are usually held in escrow by a bank escrow agent until the investor has received approval of his or her petition requesting classification as a conditional permanent resident.
- Each investment must create or preserve at least 10 full-time jobs in the U.S. within 2-1/2 years. Investments made through a government-approved regional center can count indirectly created jobs (based on projections contained in an economist's report) toward the 10-job total. All jobs created by the project can be counted toward the employment goals, not just the jobs created with the EB-5 capital.
- Because the investment must remain "at risk," there can be no guaranteed return of principal to the investors.

The investments are generally structured with the foreign investors investing in a pass-through vehicle which in turn loans money to the real estate project at a relatively low rate of interest. The loan is usually secured by a second (or third) lien on the real estate and other assets of the project in an attempt to limit the risk that the loan will not be repaid. The term of the loan is generally around five to seven years with no principal amortization. Interest rates paid by the project tend to be in the 4-5% range. In deals originated by a regional center (which in turn seeks investors for the deals it approves), the regional center may form an intermediate lending entity which receives a portion of the interest paid by the project and/or it may charge origination fees, ongoing management fees or other fees. The cost of capital to the developer is still considerably lower than the cost of capital in non-EB-5 financing alternatives.

Upfront costs for first-time EB-5 financings by a developer include the usual costs of preparing a business plan and offering documents for the project, along with structuring of the transaction, preparation of economic reports and costs of immigration compliance. (Regional centers which complete multiple transactions can achieve economies of scale with respect to certain of these costs because the documentation and the business and structural issues tend to be similar in many deals.) Some of these costs can be borne by the regional center where one is involved in consideration of the fees paid by the developer to the regional center. (Developers can also form their own regional centers.) For substantial developments, these up-front costs do not alter the fact that EB-5 capital is low-cost by comparison to more traditional forms of capital.

The typical EB-5 financing takes about three months to market to investors and an additional six to nine months to clear the USCIS approval process. It is possible to bridge an EB-5 financing and certain institutional lenders have begun to make bridge loans available based on an advance rate which is a percentage of the EB-5 subscription funds placed in escrow. EB-5 financing amounts vary greatly in size and as a percentage of the issuer's overall capital structure. The typical EB-5 financing size is about $30 million and constitutes only one tranche of junior capital in the deal. EB-5 investors investing through a regional center (the most common vehicle for EB-5 Green Cards) typically take a passive position in the project, usually as a limited partner.

EB-5 investments cut across a number of different disciplines and require experienced professionals in each, including:

- Immigration attorneys to assist in qualifying the investment for the EB-5 program and, when required, creating approved regional centers. In order to avoid conflicts of interest, the project developer will retain its own immigration attorney, and investors should engage separate immigration counsel to file their Green Card applications.
- Corporate and securities attorneys to assist in structuring the terms of the investment and conducting the securities offering to ensure compliance with applicable securities laws.
- Real estate attorneys to assist in the acquisition and management of the real estate assets.
- Finance attorneys to deal with the various levels of project debt and inter-creditor arrangements.
- Tax attorneys to help with the structure of the investment vehicles and terms.

Seyfarth Shaw maintains an EB-5 practice team comprised of attorneys in all of these areas to work with (depending on the client's role in a given transaction) developers, regional centers, lenders or other parties involved in the EB-5 financing.

In addition, in order to complete the EB-5 regional-center designation request, developers will need non-legal professionals to assist in the writing of the business plan, economists to assess the job-creation aspects of the project, accountants to review financial projections and individuals to facilitate access to foreign investors. Seyfarth's EB-5 practice group can also assist clients to coordinate the efforts of many of these third-party service providers.

A limited number of EB-5 financings have attracted scrutiny from the SEC and other regulatory agencies in the past year and this scrutiny is expected to continue. Still, properly structured EB-5 financings will continue to be a meaningful path to capital for developers with meritorious projects. (The maximum size of the opportunity is $5 billion per year under the visa quota set aside under the program.) We anticipate a consolidation of the

EB-5 program among the more experienced regional centers and developers. Seyfarth is poised to play a significant role in this re-shaped EB-5 market through its broad experience in all of the practices areas relevant to EB-5 financings. ■

Terrorism Insurance Update

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The Terrorism Risk Insurance Act of 2002 (as amended, TRIA)[1] is set to expire on December 31, 2014. While the real estate industry is intimately familiar with TRIA and the normalizing effect it has had on the insurance and lending markets after the September 11th terrorist attacks, one suspects (or fears) the broader market may not fully recall the beneficial effects of the legislation. Recognizing its importance in past years, Congress extended TRIA in 2005 and, again, in 2007. In response to the looming expiration in 2014, members of Congress and industry lobbying groups have begun debating the future of TRIA once more.

Prior to TRIA's enactment, the September 11th terrorist attacks had a far-reaching impact on the ability to obtain financing for commercial real estate projects. The acquisition, disposition and financing of trophy properties, especially in metropolitan centers, was jeopardized, as lenders continued requiring terrorism insurance and borrowers were unable to find sufficient coverage or unable to afford the cost thereof. Most practitioners at the time can offer one or more anecdotes exemplifying this recurring problem. On one acquisition, the purchaser budgeted $750,000 to obtain $300 million of insurance coverage prior to 9-11, but the same coverage cost over $6 million after 9-11.[2] The deal reportedly never closed.[3] The effects were also felt in the CMBS market. In September 2002, Moody's downgraded $4.5 billion in CMBS based on the unavailability of terrorism insurance for owners of high-profile skyscrapers or the limitations or weaknesses in the coverage available to such owners.[4]

Congress passed TRIA in late 2002 to address this market disruption, which legislation is widely credited as having restored stability to the terrorism insurance market and, in turn, to commercial real estate lending. According to Sen. Charles Schumer (D-NY), "In a post-9-11 New York, Terrorism Risk Insurance has proven to be an absolutely essential partnership between the government and the private sector that has turned rebuilding downtown Manhattan from a question to a certainty."[5]

TRIA requires insurance companies to make terrorism insurance available on terms that do not "differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism."[6] In exchange for insurance companies making coverage available, the federal government provides a backstop to the insurance industry for terrorism losses that exceed $100 million, in the aggregate.[7] The aggregate losses of $100 million must stem from a single event certified as an act of terror by the Treasury Secretary in concurrence with the Secretary of State and Attorney General.[8] Once the $100 million threshold is reached, the federal government will reimburse insurers for 85 percent of losses in excess of the insurers' deductibles.[9] The insurers' deductible equals 20 percent of the premiums directly earned by a given insurer for property and casualty insurance in the previous year.[10] TRIA caps the industry's annual liability and the government's annual payments at $100 billion, in the aggregate, after the application of the foregoing deductible.[11] Finally, TRIA contains a reimbursement mechanism that enables the federal government to recoup its losses. Currently, when aggregate losses are under $27.5 billion, TRIA requires the Treasury Secretary to collect 133 percent of a mandatory recoupment amount, which is an amount that represents the federal government's losses and is calculated by formula as set forth in TRIA.[12] The Secretary collects such losses through a surcharge on property and casualty insurance.[13] For losses occurring during or after 2012, TRIA mandates that the Secretary complete the recoupment process by September 30, 2017.[14] For aggregate losses that exceed $27.5 billion, TRIA provides the Secretary with the discretion to determine what, if any, additional amounts shall be subject to recoupment.[15]

Supporters of a further extension of TRIA are left concerned by what may transpire should the insurance backstop be removed. Senators Mark Kirk (D-Ill.) and Dean Heller (R-Nev.), in a joint letter to Senate Banking Committee Chairman Tim Johnson (D-S.D.) and Ranking Member Mike Crapo (R-Idaho), stated, "Unfortunately, the threat of TRIA expiration is a constant concern for many businesses throughout our states, particularly in Las Vegas and Chicago, where the threat of a terrorist attack is always high. The possible expiration of TRIA coverage threatens the economic recovery for many of our constituents, especially those in the event, travel, and tourism industries."[16] Pete Thomas, the Chief Risk Officer of Willis Re, believes "TRIA should be renewed because it is good for the economy. It is an economic national security issue."[17] Furthermore, recent studies of terrorism insurance indicate that many insurers would not offer terrorism coverage in the absence of TRIA and this would have a material effect on commercial real estate financing and construction.[18]

Notwithstanding such concerns, the future of the program is uncertain as the December 31, 2014 sunset of TRIA approaches. Though the past 16 months have seen the commencement of legislative activity in the Senate and House of Representatives, it is too early, at present, to determine the structure of the final legislation, if any.

Legislative activity on the reauthorization of TRIA was initially limited primarily to the House. In February 2013, eleven members of the House proposed the Terrorism Risk Insurance Act of 2002 Reauthorization Act of 2013 (H.R. 508), which would extend TRIA until the end of 2019.[19] Two other bills introduced in 2013, Fostering Resilience to Terrorism Act of 2013 (H.R. 1945) and Terrorism Risk Insurance Program Reauthorization Act of 2013 (H.R. 2146), would each extend TRIA until the end of 2024.[20] H.R. 1945 would also modify the TRIA program by requiring the Secretary of Homeland Security, instead of the Treasury Secretary, to take the lead in certifying "acts of terrorism."[21] Such certifications would occur in concurrence with the Treasury Secretary, Secretary of State and Attorney General.[22] H.R. 508 and H.R. 2146, on the other hand, would extend TRIA without modifying the TRIA program.[23]

In April, 2014, legislative activity picked up in the Senate as Sen. Schumer and a bipartisan group of eight co-sponsors introduced the Terrorism Risk Insurance Program Reauthorization Act of 2014 (S. 2244), which would extend TRIA until the end of 2021.[24] In addition to extending TRIA, the Senate bill proposes two changes to the current TRIA program. First, the bill would decrease the federal government's reimbursement of insurers, after aggregate losses reach the $100 million threshold, from 85 percent to 80 percent of losses in excess of the insurers' deductibles.[25] This decrease in federal reimbursements would phase in over five years.[26] Second, the bill would increase the threshold under which recoupment is mandatory from $27.5 billion to $37.5 billion.[27] This aspect of the bill would also phase in over five years.[28] On June 3, 2014, Republican and Democratic members of the Senate Banking Committee unanimously approved this bill by a 22-0 vote.[29] The Senate bill is now expected to advance to the Senate floor for further debate and a vote, though at present the Senate Majority Leader, Sen. Harry Reid (D-Nev.), has not yet scheduled a date on the Senate's calendar.

None of the bills formally introduced in the Senate or the House currently address a coverage option that Congress left open for further study at the time of the last TRIA extension. In 2007, TRIA instructed the Government Accountability Office (GAO) to study the availability of insurance coverage for losses due to nuclear, biological, chemical and radiological (NBCR) terrorism.[30] Terror attacks that use NBCR materials are typically excluded from terrorism insurance policies, as these policies often limit coverage to attacks using conventional weapons.[31] The GAO made several proposals in its report,[32] and while the current versions of the Senate and House bills do not incorporate any of these proposals, certain of these proposals are being discussed in drafts of the proposed, but not yet introduced, Terrorism Risk Insurance Modernization Act of 2014 ("TRIM"). A proposed outline of the TRIM Act was distributed among Republicans on the Subcommittee on Housing and Insurance by Rep. Randy Neugebauer (R-TX), the Chair of the Subcommittee, in early May.[33] The TRIM draft represents a departure from previously proposed legislation and, for reasons discussed below, has expanded the discussion as to the form a TRIA extension may take.

Prior to the issuance of the TRIM proposal, the Senate bill and one of the House bills (H.R. 508) had achieved a measure of bi-partisan support, though considerable discussion and debate were still expected before the passage of any TRIA extension. The introduction of the TRIM Act, which seeks to shift the risks of coverage away from government and towards the private sector more quickly than other proposals, appears to have gained support from some politicians who might otherwise have voted against an extension. By way of example, Rep. Jeb Hensarling (R-TX), the Chairman of the House Financial Services Committee, initially indicated he would oppose an extension of TRIA, but has reportedly recently evidenced support for the proposed TRIM Act.[34] As other members of the Republican leadership, including, Majority Leader Eric Cantor (R-VA), have also reportedly evidenced support for the proposal,[35] one could make an argument that the momentum in Congress appears, at least at present, to have shifted from a question of whether TRIA will be extended to the form such extension may take, though it is still too early to tell with any specificity.

The TRIM proposal varies from the introduced legislation in a number of ways and would, among other things:

- extend TRIA for three years;
- reduce the federal backstop for non-NBCR events from an 85 percent (government) - 15 percent (private industry) copayment split to an 80/20 split in 2016 and a 75/25 split in 2017;
- provide for a newly created distinction between NBCR and non-NBCR events, by covering NBCR events with a federal backstop utilizing an 85/15 copayment split and a $100 million per year program trigger;
- increase the program trigger for non-NBCR events from $100 million per year to $250 million in 2016 and $500 million in 2017;
- decrease the annual cap on insurer liability and government payments for non-NBCR events from $100 billion to $75 billion, after the application of the insurers' deductible, in 2017;[36]
- require insurers to establish a capital reserve fund to address future costs and losses;
- increase the recoupment of federal payments to 150 percent from 133 percent; and

- permit a voluntary opt-out of TRIA coverage for small insurance companies.[37]

One of the arguments against the renewal of TRIA in its current form has been the concern that the existence of TRIA is hindering the development of a private market for terrorism insurance. This concern is especially evident in the proposed TRIM Act, which seeks to lessen government involvement in providing a backstop for losses and increase regulation of insurance companies to ensure the insurers maintain adequate reserves on hand to cover losses. The Senate bill also seeks to pull back some of the protections afforded insurance companies under TRIA, albeit to a lesser extent and at a slower pace than that sought by the proposed TRIM Act.

Included among the arguments for the renewal of TRIA without material modification are studies which suggest that a private market solution may not be possible without government support. By way of example, the *2013 Terrorism Risk Insurance Report*, issued by Marsh & McLennan Companies, states, "Although there is private market capacity for terrorism insurance, it may not be enough to meet the demand in the marketplace should TRIA not be reauthorized. In that case, despite an ongoing exposure to terrorism events, insureds may be unable to secure adequate capacity to insure their risks, or may be unable to do so at commercially viable prices."[38] Fitch Ratings has also concluded that "it is unlikely that substantial private market capacity would arise as a substitute to [TRIA] coverage if the program is allowed to expire."[39] Moreover, the decreased availability of terrorism insurance may very well impact the CMBS market, as Fitch, among other rating agencies, "may decline to rate . . . CMBS transactions with inadequate terrorism insurance" or may lower its ratings on such transactions.[40]

Regardless of what legislation Congress may ultimately pass, most would agree that TRIA provided reassurance to the markets and helped maintain the continued availability of terrorism insurance after the September 11th attacks. Notwithstanding such past successes, the effect on the markets will almost certainly be substantial if TRIA is allowed to expire at the end of 2014. Even if TRIA is extended beyond 2014, the details of such extension, together with the timing thereof, could impact the marketplace by affecting the availability and cost of terrorism insurance coverage. These are issues that will gather more and more attention as the TRIA sunset date draws closer and the final form of any ultimate legislation becomes apparent. ■

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[1] Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 (codified at 15 U.S.C. § 6701 note (2002)); Terrorism Risk Insurance Extension Act of 2005, Pub. L. No. 109-144, 119 Stat. 2660 (codified at 15 U.S. § 6701 note (2005)) [hereinafter TRIEA]; Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. No. 110-160, 121 Stat. 1839 (codified at U.S.C. § 6701 note (2007)).

[2] JOINT ECON. COMM., 107TH CONG., ECONOMIC PERSPECTIVES ON TERRORISM INSURANCE 9 (Comm. Print 2002).

[3] *Id.*

[4] *Id.*, at 8–9; Press Release, Moody's Investors Service, Rating Action: Moody's Downgrades Eleven and Confirms Two Single Asset and large Loan CMBS Transactions Citing Terrorism Insurance Concerns (Sept. 27, 2002), *available at* https://www.moodys.com/research/MOODYS-DOWNGRADES-ELEVEN-AND-CONFIRMS-TWO-SINGLE-ASSET-AND-LARGE--PR_60040.

[5] Press Release, Sen. Charles Schumer, Schumer, Heller, Kirk, Reed, Murphy, Johanns Introduce Critical Bipartisan Agreement to Re-Authorize and Extend Terrorism Risk Insurance Program (April 10, 2014), *available at* http://www.schumer.senate.gov/record.cfm?id=350627&.

[6] TRIA § 103(c)(2).

[7] *Id.* §§ 102(1)(A), 103(e)(1)(B). The threshold was raised to $100 million from $50 million beginning in January 1, 2007. TRIEA § 103(e)(1)(B).

[8] TRIA §§ 102(1)(A), 103(e)(1)(B).

[9] TRIA § 103(e)(1)(A). The reimbursement level was lowered to 85 percent from 90 percent beginning in January 1, 2007. TRIEA § 103(e)(1)(A).

[10] TRIA § 102(4), (7). The insurers' deductibles were raised year to year until the current deductible of 20 percent was reached in January 1, 2007. *See generally, id.* § 102(7).

[11] *Id.* § 103(e)(2)(A).

[12] *Id.* § 103(e).

[13] *Id.* § 103(e)(8).

[14] *Id.* § 103(e)(7)(E).

[15] *Id.* § 103(e)(7)(D).

[16] Press Release, Sen. Mark Kirk, Kirk, Heller Urge Renewal of Terrorism Risk Insurance Act (Dec. 16, 2013), *available at* http://www.kirk.senate.gov/?p=press_release&id=951.

[17] Telephone Interview with Pete Thomas, Chief Risk Officer, Willis Re (May 23, 2013).

[18] *See, e.g.*, MARSH & MCLENNAN COMPANIES, 2013 TERRORISM RISK INSURANCE REPORT (2013), *available at* http://usa.marsh.com/NewsInsights/MarshRiskManagementResearch/ID/30732/2013-Terrorism-Risk-Insurance-Report.aspx; FITCH RATINGS, U.S. TERRORISM REINSURANCE: LOOMING UNCERTAINTY OF PROGRAM RENEWAL 1 (2013), *available at* http://cmbs.informz.net/cmbs/data/images/fitchreport-8-13.pdf.

[19] Terrorism Risk Insurance Act of 2002 Reauthorization Act of 2013, H.R. 508, 113th Cong. § 2 (2013).

[20] Fostering Resilience to Terrorism Act of 2013, H.R. 1945, 113th Cong. § 3 (2013); Terrorism Risk Insurance Program Reauthorization Act of 2013, H.R. 2146, 113th Cong. § 2 (2013).

[21] H.R. 1945 § 2.

[22] *Id.*

[23] *See generally*, H.R. 508; H.R. 2146.

[24] Terrorism Risk Insurance Program Reauthorization Act of 2014, S. 2244, 113th Cong. § 2 (2014).

[25] *Id.* § 3.

[26] *Id.*

[27] *Id.* § 4.

[28] *Id.*

[29] Press Release, U.S. Senate Committee on Banking, Housing & Urban Affairs, Senate Banking Committee Passes TRIA Reauthorization (June 3, 2014), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=d759e623-ca6c-f90e-483f-4cd485db8404.

[30] TRIA § 108(f).

[31] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, TERRORISM INSURANCE: STATUS OF COVERAGE AVAILABILITY FOR ATTACKS INVOLVING NUCLEAR, BIOLOGICAL, CHEMICAL, OR RADIOLOGICAL WEAPONS 4–9 (2008), *available at* http://www.gao.gov/new.items/d0939.pdf.

[32] *See id.* at 27–35.

[33] Bruce E. Baty et al., House Republicans Propose Three Year TRIA Reauthorization and Reduced Federal Role, MONDAQ, May 7, 2014, http://www.mondaq.com/unitedstates/x/311754/Insurance/House+Republicans+Propose+ Three+Year+TRIA+Reauthorization+And+Reduced+Federal+Role.

[34] *Id.*

[35] *Id.*

[36] While the TRIM proposal decreases the annual cap for non-NBCR events, the proposal does not clearly address an annual cap for NBCR events. *Id.*

[37] *See* Baty, et al., *supra.* A draft of the proposed TRIM Act is *available at* http://blogs.cq.com/banking-finance/wp-content/uploads/sites/5/2014/05/The-Terrorism-Risk-Insurance-Mod-erniation-Act-of-2014-Concepts-Draft.pdf.

[38] MARSH & MCLENNAN COMPANIES, 2013 TERRORISM RISK INSURANCE REPORT (2013), *available at* http://usa.marsh.com/NewsInsights/MarshRiskManagementResearch/ID/30732/2013-Terrorism-Risk-Insurance-Report.aspx.

[39] FITCH RATINGS, U.S. TERRORISM REINSURANCE: LOOMING UNCERTAINTY OF PROGRAM RENEWAL 1 (2013), *available at* http://cmbs.informz.net/cmbs/data/images/fitchreport-8-13.pdf.

[40] *Id.*

Environmental Due Diligence: What is a REC?

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Introduction

Many individuals on the business or legal side of transactions involving the transfer of real property understand the primary purposes of performing Phase I environmental due diligence: (1) gain information on the environmental conditions of a property; (2) establish defenses to liability under the Comprehensive Environmental Response, Compensation and Liability Act, or "CERCLA"; (3) secure lending; and (4) obtain insurance.

Most of these individuals also are familiar generally with the CERCLA defenses parties seek to establish by conducting environmental due diligence: (1) Innocent Purchaser Defense; (2) Bona Fide Prospective Purchaser defense (also applies to tenants); (3) Contiguous Property Owner defense; and (4) Lender Liability defense.[1]

Notwithstanding this understanding, environmental attorneys often receive the question: **What is a REC, anyway?** Simply stated, a REC, short for "Recognized Environmental Condition," is the terminology used by the environmental consultant in its Phase I Report to identify a particular, potential environmental impairment on the property. The impairment may affect the use or value of the property, the ability to obtain financing, and the availability of the purchaser's defense to CERCLA liability. As such, identifying RECs goes to the heart of why environmental due diligence is being performed.

Types of Recognized Environmental Conditions - RECs

First, let's try to muddy the environmental waters in which you've started to swim by telling you that there are two sets of definitions of "RECs" currently in use. This is because USEPA

recognizes two different ASTM due diligence standards as being adequate for establishing CERCLA defenses. For the moment, USEPA allows use of both the 2005 and 2013 standards (ASTM E1527-05, and ASTM E1527-13, respectively). In our experience, while both standards are allowed by USEPA, many consultants now use the new 2013 standard.[2]

So, for purposes of today's discussion, let's look at ASTM E1527-13, which recognizes three types of RECs: the original REC, "Historical RECs," and "Controlled RECs."

Definition of Recognized Environmental Condition

ASTM E1527-13 defines a REC as "*the presence or likely presence of any hazardous substances or petroleum products in, on, or at a property: (1) due to any release to the environment; (2) under conditions indicative of a release to the environment; or (3) under conditions that pose a material threat of a future release to the environment.*" The definition is very broad, is used as a "catch all" and is sometimes interpreted differently by different consultants. Some important points to remember are as follows:

- Central to the definition of a REC is the occurrence of a "release" whereby hazardous substances or petroleum have entered on-site or off-site soils or groundwater or some other media. Naturally occurring chemicals or substances would not be properly identified as a "REC."
- Parties want to be informed about RECs so they can address them in negotiating a purchase contract; however, there are additional environmental concerns that are not necessarily addressed that are not within the scope of an assessment meeting the requirements of ASTM E1527, such as asbestos or lead in buildings, adequacy of existing operational permits, or on-going compliance with environmental regulations. If the parties want these non-scope items addressed as part of the Phase I, they should be specifically requested (see discussion below regarding Business Environmental Risks). Even when so requested, the consultant may report his findings separately rather than identifying these non-scope items as RECs. If a condition is present, but not identified as a REC for any reason, make sure you don't ignore it in the Purchase & Sale Agreement. Neither the risk nor the liability of a condition goes away merely because it is not a REC.
- Petroleum contaminants are included in the scope of conditions that could be RECs, even though petroleum *is not covered by CERCLA, and therefore liabilities associated with petroleum releases are not protected by CERCLA defenses*.
- Testing protocols change over time. Underground Storage Tanks ("USTs") that were removed in the past may not have been tested to the degree necessary to satisfy some consultants. Accordingly, do not be surprised if the consultant identifies a former UST as a REC, even though past testing suggests either that the former UST never leaked, or that the adjacent soils were adequately remediated.

Definition of Historical Recognized Environmental Conditions ("HREC")

The new ASTM Standard defines a Historical Recognized Condition ("HREC") as "*a past release of any hazardous substances or petroleum products that has occurred in connection with the property and has been addressed to the satisfaction of the applicable regulatory authority or meeting unrestricted use criteria established by a regulatory authority, without subjecting the property to any required controls (for example, property use restrictions, activity and use limitations, institutional controls, or engineering controls)*". Within the definition of HREC are several critical phrases:

1. "has been addressed to the satisfaction of the applicable regulatory authority;"
2. "meeting unrestricted use criteria established by a regulatory authority;" and
3. "without subjecting the property to any required controls."

In practice, what these three points mean are:

1. A No Further Action ("NFA") Letter or No Further Remediation ("NFR") Letter or similar letter (or Administrative Order) has been issued by the state agency, acknowledging the past contamination has been abated to the satisfaction of the applicable state agency;
2. The property can be used for any lawful purpose, including residential;
3. There are no related deed restrictions, environmental land use covenants ("ELUCs"), restrictions on groundwater use, prohibitions on excavation, or any requirements for paving, capping, encapsulation, vapor barriers or other physical means of minimizing exposure to contaminants in soil or groundwater.

In summary, HRECs are conditions which occurred or existed in the past, but have been addressed to the satisfaction of the state, and the property can be used as if it were never contaminated (no type of deed restriction or engineered barrier needed). Generally, few environmental risks are associated with HRECs. However, as noted previously regarding former USTs, they may be reported as a HREC even though the test protocols

used at the time of removal were more lenient than current technology. In such instance (as well as others), notwithstanding that the state has signed off with an NFR, and the consultant has identified the condition (favorably) as an HREC, there may be latent or residual contamination associated with former USTs that could impact the transaction.

Definition of Controlled Recognized Environmental Conditions ("CRECs")

The new 2013 ASTM Standard defines a Controlled Recognized Environmental Condition ("CREC") as "*a recognized environmental condition resulting from a past release of hazardous substances or petroleum products that has been addressed to the satisfaction of the applicable regulatory authority (for example, as evidenced by the issuance of a no further action letter or equivalent, or meeting risk-based criteria established by regulatory authority), with hazardous substances or petroleum products allowed to remain in place subject to the implementation of required controls.*"

An example CREC would be a historic leak or spill that has been remediated to something less than "clean," so that the property may not meet residential or "unrestricted" use criteria. In this case, the "control of the REC" is the engineered barriers or institutional controls (such as a prohibition on use of groundwater) on which the NFR letter is premised: the <u>use restrictions</u> in place and often recorded in the deed or otherwise memorialized. It should be noted that the identification of a CREC does not imply that the control put in place has been evaluated for effectiveness or adequacy.

Like HRECs, CRECs may have the approval of a state agency. Unlike HRECs, however, CERCs by their nature are associated with contamination that remains on site. Thus, CRECs may affect development. CRECs may also require some type of ongoing due care or mitigation to ensure the continued validity of a NFR letter issued by the state when a site has been satisfactorily remediated, and will likely require maintenance and oversight to ensure the Bona Fide Prospective Purchaser defense.

Definition of *De Minimis* Conditions

Per the ASTM Standard, a *de minimis* condition is defined as "*a condition that generally does not present a threat to human health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies.*" This can include areas of minor staining or spills below reportable quantities. *De minimis* conditions are <u>not</u> RECs or CRECs, and generally don't pose risks that need to be addressed in purchase agreements involving only real property.

Definition of Business Environmental Risks ("BERs")

Because the goal of the ASTM standard is to establish the due diligence needed to satisfy a defense to CERCLA liability, it only requires consideration of historic releases of chemicals onto a property. However, as mentioned, there are a host of other potential environmentally related concerns that could exist with regard to a property. The ASTM standard discusses the limitations on its scope and notes that parties to a transaction may wish to have these non-scope items evaluated as well. The ASTM standard refers to these non-scope items as a Business Environmental Risk ("BER") defined under the ASTM standard as "*a risk which can have a material environmental impact on the business associated with the current or planned use of [a property].*" BERs include issues or conditions such as the presence of asbestos, lead-based paint, radon, mold, wetlands, OSHA issues, regulatory compliance issues, and endangered species or cultural/archaeological issues. These need to be considered on a site-specific basis to determine whether it is desirable to have the environmental consultant include these issues in the scope of work, so that they too will be evaluated in the course of the Phase I investigation, and addressed in a purchase agreement. For example, in an asset purchase, the buyer typically is interested in knowing whether asbestos is present in buildings being purchased. The buyer may not be interested in the seller's regulatory compliance if the building will be used for a different purpose. In contrast, if the buyer is purchasing the on-going business, it may be prudent to expand the scope of the environmental site assessment to include a regulatory compliance investigation.

Frequently Asked Questions

Q: So if there are <u>no</u> RECs, HRECs, or CRECs, is the real property okay?

A: Yes, for purposes of establishing the basis for CERCLA defenses; **however**, an environmental consultant's determination that there are no RECs, HRECs or CRECs doesn't necessarily mean there is no risk at the property, that there are no costs associated with environmental conditions when developing or operating a property, or that a site can be freely developed without consequences. For example, there may still be *de minimis* conditions or BERs associated with the property. Further, where RECs, HRECs and CRECs are identified they should be addressed in deal negotiations and the purchase agreement/lease.

Q: So if there are RECs, HRECs or CRECs, what do I do?

A: Ask your environmental lawyer. Really.

The identification of a REC, HREC or CREC can affect your transaction in a number of ways:

- Conditions identified as RECs, or CRECs are not entitled to the *innocent purchaser defense* (because, of course, by virtue of reviewing the Phase I, the purchaser or lender now has knowledge of them).
- Conditions identified as RECs, HRECs or CRECs do not preclude the use of the *bona fide prospective purchaser defense at a site, or the contiguous property owner defense*. However, due diligence only establishes the defense. To maintain the defense, after property acquisition, the purchaser must take "due care" regarding the RECs, HRECs or CRECs, which can include taking (at the purchaser's expense) a response action or doing remediation, performing other mitigation, and complying with institutional and/or engineering controls.
- Conditions identified as RECs, HRECs and CRECs should be specifically addressed in the purchase contract/lease; consideration must be made as to whether seller will indemnify for liabilities associated with the conditions, whether there are ongoing or post-closing costs or obligations associated with the conditions, whether conditions should be remedied pre-closing or post-closing, and how, when, and who should pay for them.
- Lenders are wary of RECs, HRECs and CRECs, so be prepared to address them with the lender; lenders usually require an assessment of the risks these conditions present to the borrower's ability to repay a loan, the effect of conditions on the collateral, and potential liability for the lender in a foreclosure situation should it need to manage the property or take steps inconsistent with CERCLA's lender protections.
- Generally insurers won't insure RECs, HRECs or CRECs unless the coverage is specifically negotiated, because they are known, existing conditions.
- Be mindful of who commissioned the Phase I report and who prepared it. Two consultants viewing identical conditions may reach differing conclusions as to whether a condition is to be identified as a REC, HREC or CREC, or identified at all. A Phase I Report should be carefully reviewed by the purchaser and its legal counsel, and should be considered as only the starting point in evaluating what conditions need to be addressed in the purchase agreement.

Conclusion

This primer is intended to assist in understanding the difference between RECs, HRECs, CRECS, BERs, and *de minimis* conditions. A Phase I report is the starting point for identifying environmental risks that may bear on a property transaction. Understanding the Phase I conclusions likely will impact the terms of the deal, from purchase price and insurance, to indemnities, escrows and post-closing obligations. ■

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[1] CERCLA provides a defense for a person who conducts all appropriate inquiry yet fails to discover the presence of contamination, the "Innocent Purchaser Defense," CERCLA Sections 107(b)(3) and 101(35). A person who discovers contamination during its investigation but did not cause it can qualify for the bona fide prospective purchaser defense, CERCLA Sections 107(r) and 101(40). Contiguous landowners have protection by meeting the requirements of CERCLA Section 107(q). Lenders enjoy protection under CERCLA Section 101(20)(E) so long as they do not participate in management of the facility.

[2] Please note that when reviewing a Phase I it is important to know under which standard the Phase I was written.

Issues in Representing Pension Funds

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Representing pensions funds in real estate transactions can sometimes raise unique and challenging issues. Pension funds come in basically two flavors--public and private. Public pension funds hold pension monies for state and municipal employees like teachers, fire and police officers and governmental workers. Private pension funds benefit employees of corporate entities, especially large companies. Due to sensible investment strategy as well as the legal requirements to diversify, many pension funds acquire and hold real estate assets. Following are some of the more common issues that such investment raises:

- **Decision Making.** Fund investments are handled through advisors, whose relationship to the fund is governed by an investment management agreement. Balancing the needs and desires of both the fund and the advisor can be difficult, but a familiarity with the management agreement is often useful, as it may speak directly to an issue at hand. Regardless of whether it is the advisor or the fund who selects counsel, the actual client and counsel's ultimate duty is to the fund. In any difference of opinion between the two, the fund has the last word; however, in many situations, experienced counsel can facilitate a solution. For example, the two may disagree over the amount of

a limitation of damages provision. The fund is sensitive to limiting its liability to the greatest extent possible while the advisor may believe that the market requires more exposure. Counsel can guide a resolution based on experience in other deals with other funds or with the same fund but a different advisor, thus achieving a "market" deal and still giving the fund comfort that it is acting as a responsible fiduciary in protecting its beneficiaries. Even where the advisor has authority to act under the investment management agreement (such as approval of the closing statement), counsel still acts to insure the interests of the fund are protected.

- **Guaranties.** Typically, each fund property is held in a single-purpose entity without other assets or, occasionally, with a few other assets not exceeding a pre-determined maximum value. When such an entity is selling or financing the asset or entering into a development agreement which requires significant future contributions, this can create problems because the purchaser, the lender or the developer will have no other assets to look to in the event of a default. Many funds have organizational documents or statutory authority which absolutely prohibit the parent fund (as opposed to the ownership entity) from guaranteeing ANY obligation and even those that do not are concerned that taking on such liability would be a breach of their fiduciary duty. Some funds are willing to guaranty against default which they can control, such as "bad boy" carve outs from loans, but are unwilling to cover any loss from "market risk" situations, such as a reduction in income due to a failure to lease the property or a reduction in market rents or property value. This may make some transactions with some third parties much more difficult. In the case of post-closing liability or required construction contributions, escrows or letters of credit may solve the problem. In the case of loans, a fund may have to settle for a lower LTV than what would have been available with a more robust guarantor. Especially where the fund is absolutely prohibited from giving a guaranty, it is critical that this issue be identified as early as possible in the process, so that the parties can address whether there is a possible "work around" or whether the lender must be eliminated from consideration, thereby avoiding unnecessary costs. Such early identification is particularly important with some regional or local lenders or developers who are doing their first deal with a pension fund.

- **Tax Issues.** Many of the biggest differences between transactions with pension funds as opposed to other entities revolve around tax issues. The funds and their title-holding entities are exempt from Federal taxes, but the Federal exemption does not necessarily translate to an exemption from state taxes, so the fund's counsel must investigate the possible impact of both state income and franchise taxes. Eliminating or minimizing such taxes may require a restructuring of the ownership (changing from a corporation to a partnership, for instance, or reducing the amount of paid-in capital as much as possible), which changes may then result in guaranty issues (see above). Also, having a Federal tax exemption does not end the concern about such taxes. Private pension funds are subject to tax on "unrelated" income (UBTI) and, although public funds are probably not (there is some disagreement), they usually want to avoid it as well. Thus, in any acquisition with pension funds, counsel must review the income sources to insure no UBTI is present. Typical instances of UBTI are hourly or daily parking lot income, rental of personal property and re-sale of utilities for a profit. Often, counsel can restructure these income sources to re-characterize them as non-UBTI.

- **Partnerships.** Private pension funds are subject to ERISA and public pension funds often have similar, state-imposed requirements. Of particular concern in the real estate context is the requirement that the funds act as a fiduciary with respect to its beneficiaries, a categorization which carries with it a number of statutory and common law requirements, some of which must be passed on to third-party providers. This can create issues with developers in construction agreements and property managers, but it is often solved by providing some additional information so that they understand that the "additional" responsibilities thus imposed are actually the same or very similar as those the management relationship would impose in any event. ■

Easing Into Easements: A Look at Some Basics

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Easements are a valuable tool in the developer's toolbox, and can be a cost-effective means of making land viable for development. Here we present an overview of some common easements, the benefits of entering into easement agreements, and certain pitfalls that should be observed when owning, buying, developing or financing real property.

Access/Utility Easements

The availability of utilities on a parcel of land and an adequate means of access to and from that parcel are essential for the viability and success of any land development project. However, a parcel that is attractive for development may be deficient in one or more of these basic respects. Instead of purchasing adjacent land that would provide a sufficient means of access to and from the parcel, or a means of delivering utilities to the parcel, developers may consider a more economical approach: obtaining an access or utility easement from neighboring land owners. Access easements permit persons to physically cross over the land of others in order to gain access to and from a parcel that is landlocked or that otherwise has poor access to a public road. Access easements tend to be particularly important for outlot parcels that do not abut a public right-of-way. Utility easements enable a landowner to provide electric, gas, telephone, water, sanitary sewer and other services over, in, through and across the land of others to make the "benefitted" parcel land more useful and valuable. Utility easements are often coupled with an access easement in order to allow the beneficiary of the utility easement, together with those that provide the utilities, to enter the easement area to inspect, maintain and repair the utility installations. Persons obtaining access and utility easements would be wise to ensure that such easements are perpetual and run with the land to the benefit of successor owners of the benefitted property, and persons granting such easements would be wise to ensure that insurance and maintenance concerns are properly addressed in an easement agreement.

Reciprocal Easement Agreements

Reciprocal easement agreements (REAs) support the notion that sometimes the whole is greater than the sum of its parts. Instead of developing and operating their respective properties with self-contained services and access points, owners of adjacent properties often enter into REAs to facilitate the creation of what is, in effect, a harmonious integrated development, with mutual rights of access, parking, and utilities. Given that multiple parties stand to benefit in some fashion from an REA, the parties will typically require that the liens of any existing or future lenders be made or remain subordinate to the REA in order to avoid the possibility that any portion of the subject property could be stripped of its obligations under such REA in connection with the enforcement of any such lien. When evaluating the purchase or lease of property that is subject to an REA, one must pay careful attention to the maintenance obligations and required assessments contained therein that burden such property. These obligations typically run with the land and must be factored in among the operating expenses in the project budget. When purchasing or financing a property affected by an REA, one should consider requesting estoppels from each of the other parties to the REA in order to determine whether the property is in compliance with the terms of the REA and whether there are any outstanding assessments or defaults for which the new owner may become responsible or as a result of which, the new owner may suffer the consequences. A purchaser of or lender to such property should consider obtaining title insurance coverage over any such assessments or defaults that could result in a lien on the property or loss of rights. (Note, however, that many REAs will provide that if a lender obtains title to such property in connection with enforcement of its lien, the property will not be subject to a lien for any unpaid assessments.)

What to do about the easement that crosses under an improvement?

In addition to considering entry into REAs, when planning a new project a developer must be careful to identify every easement that affects the property and to learn about how that easement may affect the development. Easements are rights in land that cannot be treated lightly; if one builds improvements on top of an easement, the owner of the benefitted property may have the right to cause those improvements to be removed, at the developer's cost. It is important that a developer, when conducting its due diligence, obtain a detailed ALTA survey of the land in order to identify and map out the location of easements. As the use of a parcel of land changes over time, so may the ongoing need or use of an existing easement. Thus, if a developer learns of an easement that appears to get in the way of development, the developer should investigate whether the easement has been abandoned. Abandonment may be apparent if the related installations have been removed or the area has

become overgrown with plant life. Obtaining written evidence of the abandonment signed by the owner of the easement is often the best course of action. Another approach is obtaining affirmative title coverage against any loss sustained as a result of the use of an easement that was presumed abandoned; this title coverage is only available if the title company agrees that the easement is almost certainly abandoned, and thus not a significant risk. With respect to an easement that is located under any improvements and for which proof of abandonment cannot be obtained, the parties should confirm that any facilities installed in connection with such easement can be accessed by a manhole or some other means of access (other than tearing down the improvement located on top of the easement area).

Understanding how easements can be used to increase the usefulness of land is an important part of the calculus in determining whether a project should move forward. ■

DSTs as Borrowers: Financing Issues with Delaware Statutory Trusts Designed to Qualify as Replacement Property for Section 1031 Exchanges

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After taking a back seat to tenant-in-common ("**TIC**") structures prior to the financial market meltdown of 2008-2011, the Delaware Statutory Trust ("**DST**") structure has become the vehicle of choice for real estate investment programs structured to qualify as replacement property under Section 1031. DSTs present unique issues and challenges to lenders, which Seyfarth Shaw, as a firm that regularly counsels both program sponsors and lenders, is particularly well positioned to resolve.

This article briefly describes the rules applicable to DSTs and the landscape faced by lenders seeking to make loans to such entities.

The DST Structure

The DST as a vehicle for Section 1031 exchanges was blessed by the IRS in Revenue Ruling 2004-86. In this ruling, the IRS held that a beneficial interest in a DST that owns real estate will be treated as a direct interest in real estate, and thus "like kind property" with other real estate for purposes of Section 1031, if certain conditions are met.

From the lender's perspective, the DST structure varies from the TIC structure in two important ways:

- **Management and control of property ownership:** The TIC structure requires unanimity of multiple investors for certain critical decisions. In contrast, all decision-making authority for a DST is held by one person: a sponsor-affiliated trustee. As a result, DSTs are much more agile decision makers than TICs.
- **Structural simplicity:** The TIC structure requires a Tenancy in Common Agreement to which the investors are parties, deeds to each investor, a management agreement or master lease, and the execution of loan documents by the investors. By contrast, in a DST structure, the real estate is owned by one party and there is only one borrower on the loan documents -- the DST. As a result, it is much more efficient to close and manage a loan to which a DST is a borrower.

DST Limitations

Nevertheless, there are meaningful restrictions on DSTs. Specifically, in order to qualify as replacement property for purposes of Section 1031, DSTs must be designed in a way that prevents the DST and its trustees from violating the "seven deadly sins." This means:

1. A DST cannot raise new capital after the initial offering closes.
2. A DST cannot renegotiate or enter into new financing unless there is a tenant bankruptcy or insolvency.
3. A DST cannot renegotiate any of its leases or enter into new leases unless there is a tenant bankruptcy or insolvency. Note that this restriction can be circumvented for multifamily, self-storage and other high-turnover, multi-tenant properties through the use of a master lease structure. In a DST master lease, the master lease is a long term triple net lease between the DST and a sponsor-affiliated master tenant. The master lease is designed so that the master tenant can enter into subleases with space tenants at the property.
4. A DST cannot reinvest the proceeds from the sale of its property.
5. A DST cannot redevelop property and is limited to preforming only normal maintenance and minor nonstructural repairs unless required to do more by law.

6. A DST must hold its reserves in short-term debt obligations.

7. A DST must distribute all cash, other than normal reserves, on a current basis.

If an issue arises that a DST cannot address without violating these "seven deadly sins," the trust agreement for the DST requires it to convert into an LLC, which can then undertake actions the DST itself is not allowed to do. To avoid the risk of a "comatose" DST, the loan documents and the DST's trust agreement can allow the lender to cause the conversion of a DST into an LLC.

Due to the limitations imposed by the "seven deadly sins," DSTs are not appropriate investment vehicles for all property types. They are best suited for properties with long-term, triple-net leases to creditworthy tenants. They can also be used for properties with more frequent leasing cycles through the use of the master lease structure described above, including student, multi-family and senior housing, hospitality and self-storage facilities.

Lending Challenges

Although DST structures are now accepted by many lenders, including several CMBS lenders, for Section 1031 investment programs, they do present certain challenges to lenders. Among those challenges:

- **Limited ability to address emergencies:** The inability of the DST to raise additional capital, refinance, renegotiate existing financing or enter into new leases (except in the limited circumstances described above), limits the DST in responding to emergency situations. Nevertheless, in the experience of the authors of this article, because most property problems are the product of tenant cash flow difficulties that signal a tenant insolvency, most property problems can be dealt with within the DST structure. To address those situations where a DST cannot address those problems, the DST would convert to an LLC, as described above. As a result, heading into transactions, lenders should understand the conversion process and pre-approve the LLC Agreement, which is typically attached to the DST's trust agreement. One point of interest is that, under Delaware law, the conversion of a DST to an LLC is a "single entity" reorganization that does not cause an actual or deemed transfer of the DST's property.

  It is important to note that the conversion does not result in a change of control of the property; rather, it is merely a change in the form of ownership. The sponsor-affiliated trustee of the DST becomes the manager of the LLC with the same scope of authority as it held in its capacity as trustee. Even though a DST to LLC conversion does not technically result in the transfer of the underlying property for Delaware state law purposes, lenders typically require a date-down of their title insurance policies and an acknowledgement of the LLC's position as borrower under the loan documents.

  Once lenders understand the conversion process, including the fact that the borrower essentially remains unchanged other than its entity form, they are typically able to get comfortable with the DST structure.

- **High sensitivity to partnership characterization:** DSTs, like all investments intended to qualify as replacement property for purposes of Section 1031, must constitute direct interests in real estate and not interests in a tax law partnership. As a result, loan arrangements and documentation must be sensitive to issues that give rise to a risk of partnership characterization for the DST investment, including the issues described below:

  - **Who is the borrower?:** In non-DST structures involving long term "triple net" master leases, lenders may require the master tenant to execute the note, and may obtain a leasehold mortgage from the master tenant in respect of its leasehold interest. However, such arrangements cannot be used in a Section 1031 investment because they make the master tenant a co-borrower with the DST, and thus raise significant risks of loss sharing as between the investors and the master tenant. Lender concerns are often satisfied, however, through an assignment of leases and rents by the master tenant and a subordination agreement from the master tenant, and by other vehicles that place cash flow from an investment under the effective control of the lender in a default situation.

  - **Limits on bridge financing:** For a DST to qualify as replacement property in a Section 1031 exchange, only the DST can be the borrower on the permanent financing. In addition, the DST cannot borrow additional funds if bridge financing is needed to acquire the property. This is because such financing would be treated (on the look-through basis applicable to DSTs) as undertaken by DST investors themselves, which could raise potential tax problems for the investors. To resolve this issue, the sponsor-affiliated entity that is the initial owner of the unsold beneficial interests in the DST can obtain short term financing and pledge the unsold DST interests as collateral for such financing. Under this arrangement, the bridge financing would be paid down with proceeds from the sale of DST interests to investors.

Although DSTs present certain challenges to sponsors and lenders, those challenges generally can be addressed without jeopardizing the Section 1031 treatment desired by investors. Furthermore, in the aftermath of the financial market crisis of

2008-2011, it is now commonly understood by the investment and finance communities that work with Section 1031 investment programs that the burdens of the DST structure are counterbalanced, to a significant extent, by the unified management and structural simplicity that DSTs present over TIC ownership structures. As a result, DST structures are growing in popularity as a Section 1031 investment vehicle for sponsors, lenders and investors. ■

Bankruptcy: Assignment of Voting Rights

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One of the more effective risk-mitigation legal tools used by senior real estate lenders is the single purpose entity borrower. Among other things, having a single purpose, bankruptcy remote borrower makes avoiding the risks of bankruptcy easier. Even in bankruptcy, if the borrower is truly single purpose, and it keeps the universe of creditors small, the senior secured lender will have an easier time defeating any plan of reorganization proposed by the borrower because it will control all of the legitimate classes of creditors by virtue of the voting rights associated with its large, usually undersecured claim.

Sometimes, however, a borrower will need junior debt, and sometimes that debt will not be available on a mezzanine basis. If the senior secured real estate lender is willing to permit a junior loan, it generally will want to tie the hands of the junior creditor as tightly as possible, in either an intercreditor or subordination agreement. One of the ways senior secured lenders implement this hand-tying is to have the junior creditor "assign" to the senior lender its right to vote on any plan of reorganization in a borrower bankruptcy. If such an assignment is enforceable, the senior secured lender will be able to maintain the possibility of controlling the voting in all the creditor classes in a borrower bankruptcy, thereby preventing confirmation of a plan without its consent.

The assignment of the voting rights of the junior lender is important because of the way confirmation of a plan works under the Bankruptcy Code. Section 1122 provides that a plan of reorganization must provide for classes of creditors, and that classes must contain claims that are similar. In most single asset real estate cases, there should be only two classes of creditors - a class of secured claims, which is typically the secured claim of the senior secured lender, and a class of unsecured claims. The class of unsecured claims usually includes the unsecured portion of the senior lender's claim - the amount by which the senior lender's claim exceeds the value of the collateral. Section 1129 of the Bankruptcy Code contains the requirements for confirmation of a plan. Section 1129(a)(10) requires that, to be confirmed, a plan must have at least one class of creditors that is both impaired under the plan and that accepts the plan. Under Section 1126, a class accepts a plan if the creditors in the class accept the plan by 2/3 in dollar amount and 1/2 in number. So, in a simple case involving a single asset borrower and two classes of claims (secured and unsecured), the secured lender would have a veto over any plan in the case so long as its unsecured claim amounted to more than 1/3 of the overall amount of unsecured claims, because the secured lender would be able to cause both classes to vote "no" on any plan.

In cases involving real estate assets, the fight is normally over the unsecured class or classes, and how such classes are constructed. Borrowers often try to create more than one unsecured class (often called "gerrymandering"), hoping to create one that it can impair and that will vote for the borrower's plan. Borrowers will sometimes "artificially impair" that class - for example, they will pay the class in full 30 days after the effective date, even though the borrower has the cash on hand on the effective date to make the payment - with the delay purportedly constituting "impairment" of the class. Gerrymandering and artificial impairment are regularly litigated issues in real estate bankruptcy cases. However, if there is junior secured debt, and the debtor can reach an agreement on plan treatment with the junior secured creditor (whose claim can more easily be separately classified), the borrower's plan can satisfy 1129(a)(10) without any attempt at "gerrymandering" the unsecured claims or creating an "artificially impaired" class. If, on the other hand, the senior lender controls the vote of the junior lender, that option is not available, and confirmation of a plan over its objection returns to the configuration described above - where the senior secured lender often has an effective veto.

Courts have split on the enforceability of an assignment of voting rights in bankruptcy. The first few cases on the subject found that such assignments were unenforceable. In re Hart Ski Mfg. Co., 5 B.R. 734 (MN 1980); In re 208 N. LaSalle Street, 246 B.R. 325 (ND IL 2000). In short, these courts found the assignment to be unenforceable for four (4) reasons:

1. Section 1126 of the Bankruptcy Code says that a "creditor" may vote its claim, and the Bankruptcy Code cannot be overridden by agreement;

2. Section 510 of the Bankruptcy Code, which confirms the enforceability of subordination agreements in bankruptcy, does not support enforcement of provisions in such agreements other than those that result in subordination;

3. Federal Rule of Bankruptcy Procedure 3018(c), which permits voting by an "agent", does not lead to a contrary result, because Bankruptcy Rules cannot contradict the Bankruptcy Code, and because an agent must act in the interest of its principal; and

4. Enforcing such provisions would eliminate a junior creditor's role in the bankruptcy case, which is bad policy.

Hart Ski and 208 N. LaSalle Street created serious question about the enforceability of the assignment of voting rights in a bankruptcy case, as there was for a time no contrary case law. Then in 2006 Judge Margaret Murphy addressed the enforceability of voting rights assignments in In re Aerosol Packaging, LLC, 362 BR 43 (GA -2006), a case in which the author represented the senior secured creditor. In Aerosol Packaging, Judge Murphy held that:

1. Section 510 of the Bankruptcy Code says that subordination agreements are enforceable to the extent enforceable under state law, and there was no indication in that case that the voting rights assignment at issue was not enforceable under applicable Georgia contract law;

2. Section 1126 of the Bankruptcy Code gives voting rights to a "creditor", but does not address at all whether those rights can be assigned or bargained away; and

3. Federal Rules of Bankruptcy Procedure 3018 and 9010 say that agents may vote claims - and some agents (i.e agencies coupled with an interest) can and do act for their own benefit and not for that of the principal.

Cases since Aerosol Packaging have come down on both sides of issue. In re Coastal Broadcasting Systems, Inc. 2012 WL 2803745 (NJ 2012)(enforced); In re Croatan Surf Club, Inc., 2011 WL 59099199 (NC 2011)(not enforced); Matter of Avondale Gateway Center Entitlement, LLC, 2011 WL 1376997 (AZ 2011) (enforced).

The Matter of Avondale case may be the most interesting of these, since the agreement at issue there did not even contain any express language assigning voting rights. Instead, the court relied on the following **subrogation provision**:

"[Junior] agrees that [senior] shall be subrogated to [junior] with respect to [junior's] rights, liens, and security interests, if any, in any of the Borrower's assets and the proceeds thereof (excluding, however, [junior's] right under any pledge of Borrower's membership interests made under the Subordinate Debt Documents) until the Senior Debt shall have been paid in full."

From that language, the Court inferred an assignment, and then found such an inferred assignment to be enforceable.

The issue of the enforceability of assignments of voting rights is an important one. The ability to obtain voting rights from a junior creditor supports the overall structure of the single asset bankruptcy remote borrower. Although case law continues to develop in this area, there is no certainty as to how the issue will ultimately be resolved. In the interim, senior secured lenders should consider some of the following measures to enhance the chances of their clauses being enforced:

1. Be as specific as possible about the assignment of the right to vote. Consider reference to specific Bankruptcy Rules;

2. Consider providing for the assignment to the senior secured lender of the junior lender's entire claim, not just the assignment of the right to vote, or obtaining an option to buy the junior claim for a nominal amount (excluding, possibly, in either case, the right to a distribution under such claim). ■

SNDA Considerations During Lease Negotiations: Selected Perils for Tenants and Landlords

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In recent years, the New York City real estate market has seen an uptick in the frequency of sale-leaseback transactions. A number of these transactions involve related entities and some lease negotiations are yielding increasingly tenant-friendly provisions. While a tenant-friendly lease is not necessarily unfriendly to the landlord, such leases can create other issues down the road. Both tenants and landlords should be mindful of this and should anticipate that some tenant-friendly provisions will need to be subordinated to a future mortgage or ground lease with respect to the property. In this article, we point out a number (though, by no means all) of the potential pitfalls in negotiating a lease without properly contemplating future subordination of the lease.

To successfully negotiate a lease, the parties involved must recognize their best interests while simultaneously navigating a path through unusual provisions that may raise eyebrows down the road.[1] Tenants want to protect their leasehold interests while landlords, among other things, want all leases for space at their properties to be automatically subordinate to existing or future mortgages. Sale-leaseback tenants or other large, profitable or anchor tenants ("**Major Tenants**") can have significant negotiating clout, resulting in lease provisions which can, among other things, handicap the landlord's ability to finance the property or enter into a superior ground lease in the

future, particularly if such tenants are unwilling to subordinate those provisions to a mortgage or ground lease or, at the very least, engage in a meaningful back-and-forth with the lender or ground lessor, as applicable, to obtain a mutually agreeable Subordination, Non-Disturbance and Attornment Agreement (an "**SNDA**").

Of course, where leases are automatically subordinate to existing or future mortgages or superior ground leases, SNDAs are unnecessary. But in some sale-leaseback transactions and other cases, tenants have been successful in negotiating automatic subordination provisions out of their leases. In these cases, the subordination provisions often contain a contingency that the tenant obtain an SNDA from any future lender or ground lessor. However, if the lease contains provisions that may not be considered market by a lender or ground lessor, language that the tenant shall accept the lender's then-current form of SNDA, while helpful, may not be sufficient to address certain negotiated provisions of the lease. Accordingly such provisions may require specific attention during the lease negotiation process. Some examples of these lease provisions are as follows:

- **Treatment of casualty proceeds and condemnation awards.** Many standard form leases provide that the landlord controls the adjustment and distribution of such proceeds and awards. While it is beneficial for a landlord to control insurance proceeds and condemnation awards, thus allowing them to control how such funds are applied to the restoration and repair of the property, some Major Tenants may want this power. Major Tenants tend to invest their own money into significant improvements to their leased spaces. In these cases, it may be more important to the tenant to control proceeds and awards than it is to the landlord. Depending on the size of the tenant and the type and quality of the improvements, these scenarios may suit some landlords as well.
- **Control of rebuilding and restoration.** Similar to the treatment and allocation of insurance proceeds and condemnation awards, standard provisions dealing with rebuilding and restoration of damaged property tend to vest control over these processes with landlords. Again, though, Major Tenants may negotiate provisions giving them control of rebuilding and restoration, enabling such tenants to restore their own improvements. While some landlords prefer to maintain control of the repair and restoration processes, others may be content to cede control where the property will be restored to the specifications of a top-flight, desirable tenant. Some potential lenders, however, may insist that a tenant's right to control rebuilding and restoration be subordinated to the lender's rights; however, other lenders may acquiesce to tenant-controlled restoration, provided that the tenant's use of any insurance proceeds is conditioned on the lender's control of disbursements.
- **Rights of first offer ("ROFOs") and rights of first refusal ("ROFRs").** Major Tenants sometimes negotiate ROFOs or ROFRs in order to protect their investment in the leased space. While a tenant may be comfortable with the landlord with whom the lease was negotiated, the tenant may not be comfortable with a new landlord following the sale of the property or the tenant may simply desire to purchase the property for its own use. Most landlords are more likely to grant a ROFO rather than a ROFR as the former simply grants the tenant the right to negotiate with the landlord before the landlord goes to market. A ROFR, which typically allow the tenant to purchase the property on the same terms as a third party, is more restrictive and less desirable from the landlord's point of view as it is far more difficult to market a property and get potential buyers to negotiate if there is a ROFR.
- **Tenant's right to cure defaults under a mortgage.** While this is an unusual provision, Major Tenants may think it beneficial for a variety of reasons. Landlords, too, may think such a provision is beneficial as it seemingly allows the landlord a reprieve from what would otherwise be a default under a mortgage. However, the most significant issue with such a provision is that any future lender will not have agreed to a tenant cure right and may not want to allow it.

These examples of tenant-friendly lease provisions can create real problems down the road when the landlord attempts to finance the property or enter into a superior ground lease. For example, most loan documents and ground leases provide that the lender or ground lessor, as applicable, will control insurance proceeds, condemnation awards, and rebuilding and restoration to ensure that the value and character of the property is maintained. In this case, the tenant will likely be asked to subordinate its rights to such proceeds to those of the lender or ground lessor, particularly where these provisions hamstring the landlord's options (*e.g.*, where the lease terms require the landlord to rebuild or restore the property regardless of when during the term of the lease (or the loan) the casualty or condemnation event occurs). The same is true for ROFOs and ROFRs, particularly where the tenant's rights arise following a casualty or condemnation, or in the event of foreclosure. A tenant's right to cure defaults under a mortgage, however, can cause other problems because, for example, the lender will likely not have performed all due diligence required by federal regulations and the specific lender's internal policies, including the lender's "Know Your Client Policy", with respect to the tenant.

During lease negotiations, both tenants and landlords should contemplate the effect these provisions may have on future financeability of the property as well potential concessions that will be necessary in an SNDA with respect to certain lease provisions. Landlords should also be prepared to provide

additional assurances to lenders or ground lessors where tenants hold fast to their negotiated provisions, such as an additional guaranty for losses suffered as a result of those provisions. Maintaining this kind of flexibility and practicality beyond the signing of the lease will facilitate the landlord's ability to obtain financing or enter into superior ground leases while at the same time preserving (to a certain extent) the tenant's rights under the lease. ■

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[1] The same is true not just when contemplating future financing, but also potential assignments and assumptions of such leases; however, this is beyond the scope of the present article.

Rights of First Offer - Drafting to Preserve Landlord Flexibility

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As the competition to clear vacancies escalates in many office leasing markets, more prospective tenants are able to extract concessions that were once only the province of larger users. This article will focus on one of those concessions - the "right of first offer" or "ROFO".

A ROFO is an expansion right. It gives a tenant a "first look" at leasing other space that becomes "available" during the tenant's lease term before the landlord takes the space to the overall market. Tenants like ROFOs because they provide an opportunity to bid on desirable space before the market can drive up the rent for such space, without requiring that the tenant make an upfront commitment at lease execution. From the landlord perspective, a ROFO is seen as the least harmful method for a landlord to accommodate a tenant's future expansion needs without overly encumbering its building. Because the ROFO rights are triggered early in the leasing process for the "available" space, the ROFO can be addressed with minimal disruption to overall leasing efforts.

However, a broadly defined ROFO provision can significantly limit the landlord's flexibility in accommodating the needs of the current occupant of the ROFO space, and thus can frustrate a landlord's overall leasing plan for the building. This article will focus on drafting the ROFO provision narrowly in order to preserve this flexibility. As discussed below, the keys are (1) limiting the number of overall times that a tenant's ROFO is triggered and (2) narrowly defining what constitutes "available" space for the purpose of triggering the ROFO.

(1) Limiting Overall Occurrences of the ROFO

Most ROFO provisions have clear conditions that must remain satisfied for a ROFO beneficiary's right to vest at the time the applicable space becomes available. These generally include that the tenant is not in default, that a minimum term still remains under the ROFO beneficiary's lease, and that the ROFO beneficiary not have subleased a substantial portion of its own space. Because the granting of a ROFO is predicated on the ROFO beneficiary being in good standing and in a growth mode, these conditions are not problematic.

A common step is to minimize the number of times that particular space is subject to the ROFO. In particular, a landlord may expressly state that the ROFO is a "one-time" right as to each particular block of space that becomes available. This means that such space will no longer be considered "available" later in the term if the ROFO beneficiary previously passed on the space, even if it becomes vacant a second time during the term of the ROFO beneficiary's lease. For example, assume that Tenant A enters into a 10 year lease for space on the 6th floor that contains a ROFO on any other space that becomes available on the 6th floor. Two years later a 6th floor suite becomes vacant. Tenant A is offered the space under its ROFO and Tenant A declines to lease same. Landlord subsequently enters into a 3 year lease for such suite with Tenant B. When and if Tenant B's 3 year lease rolls over, must landlord offer the same space again to Tenant A? Not if the ROFO provision was clear that Tenant A's ROFO right was "one-time", and extinguished as to particular space when Tenant was initially offered the space and declined.[1]

Limiting the application to the ROFO to a "one-time" right is often readily agreed to by smaller tenants, or by tenants with shorter lease terms that lack extension options. Because there is less likelihood that the same space will become available more than once during its term, one bite of the apple is often enough. However, for tenants with sufficient bargaining power, a landlord may need to accept a recurring ROFO (i.e., one that will apply each time the space becomes available during the ROFO beneficiary's lease term). Given this reality, narrowly defining "availability" is helpful in achieving a workable ROFO provision.

(2) Defining Availability

Perspectives on whether ROFO space is truly "available" to be leased by the ROFO beneficiary can differ greatly. To a landlord, ROFO space is not "available" if the current occupant of such space is interested in extending its occupancy, regardless of the then status of that occupant's express rights to extend. However, in the view of many ROFO beneficiaries, if the landlord and the current occupant of the ROFO space want to enter into a new arrangement with respect to such space that is subsequent in time to the date that the ROFO was granted, the ROFO should take precedence. Under many ROFO provisions, the tenant's argument would prevail. This can put the landlord

in the unfortunate position of not being able to fully negotiate an extension or expansion of the relationship with the occupant of the ROFO-encumbered space without first going through the ROFO process. Because of this conflict, a landlord needs to draft "availability" narrowly, with appropriate exclusions.

Certain exclusions as to what constitutes "available space" are generally not controversial. For example, space is typically not "available" under a ROFO if the space was vacant at the time the ROFO was granted. Similarly, there is general agreement that space is not "available" for the purposes of the ROFO until the lapse or expiration of all express renewal or expansion rights held by the occupant of the ROFO space, so long as such rights existed at the time the ROFO was granted. As there is nothing a landlord can really do about other tenant rights that predate the ROFO and occupancy of the ROFO beneficiary, ROFO beneficiaries are content to "wait out" these existing extension terms and expansion rights.

A trickier situation arises if the landlord and the occupant of ROFO-encumbered space want to enter into a new or modified arrangement after the ROFO was granted. For example, assume that Tenant C is granted a ROFO today on space currently occupied by Tenant D. Tenant D currently has no express renewal rights, or perhaps only has an existing 5 year extension. Later, Landlord and Tenant D decide that it is advantageous to extend Tenant D's term by way of subsequently granting another 5 year renewal term; or, maybe they want to extend for only 1-2 years rather than pursuant to the existing 5 year option. Under many ROFO provisions, which are subordinate only to "such extension rights as are in effect on the effective date of the granting of the ROFO", the landlord could not enter into either of these arrangements with Tenant D without first offering the space to Tenant C. These situations significantly limit the landlord's flexibility to address the needs of Tenant D.[2]

Or, assume Tenant C has a recurring ROFO on the 6th floor. A 6th floor suite becomes vacant, Tenant C declines, and Landlord enters into a short term lease with Tenant D for a suite on the 6th floor, without extension options. But then Tenant D grows, wants space on another floor, which only makes sense for the landlord if the lease term is simultaneously extended for Tenant D's initial 6th floor suite. Can the landlord enter into such an extension without implicating Tenant C's ROFO? When tenants insist on recurring ROFO's, they will usually readily agree that their rights to the space on a second go-around are subordinate to any renewal or extension rights that may have been granted in such subsequent tenant's initial lease. But that would not help the landlord in our example - because at the time of Tenant D's lease, Tenant D may not have warranted an extension term, and thus such right was not in its "initial lease". But Tenant D's circumstances changed, and Landlord wanted the flexibility to expand that relationship without implicating Tenant C.

So, from the Landlord's standpoint, it is helpful to define "availability" in a way that permits the landlord to grant extension periods and renewal rights to occupants of ROFO encumbered space. For example, if the ROFO had clear language that Tenant C's ROFO is subordinate to "any renewal or extension rights that may be granted to any current occupant of [ROFO Space] at any time", the issue described above is obviated. By carving out the ability to enter into extensions or renewal rights with the occupant at any time, landlord has preserved the flexibility of maintaining and expanding a relationship with Tenant D without implicating Tenant C.

But carving out the ability to renew or extend leases with current occupants does not cover every scenario for the landlord. What if space on the 6th floor that is subject to a ROFO is occupied by a tenant that has some space under a prime lease and some under a sublease, and when the sublease expires the landlord prefers to enter into a direct lease with the subtenant rather than involve the holder of a ROFO? When the sublease expires, is the space "available" to trigger the ROFO? Under most ROFO provisions, the answer is probably yes. If the landlord wished to preserve flexibility in this scenario, landlord needs to define "available" in a manner that excludes any new lease arrangement with any "occupant" in that space.

A final drafting note. Even the most elegantly drafted and administered ROFO provision can become victim to uncertainty as to whether the landlord actually adhered to the provision and offered the space when obligated. Notices of offers can get misplaced after being sent, or there can be some disagreement after the fact whether an offer was required. In order to mitigate these situations, landlords may wish to add an estoppel requirement to the ROFO provision, wherein the landlord would have the right to require that the tenant confirm that the ROFO was declined, waived, or not applicable, as appropriate for the particular situation. The landlord may also want to include language that if same is not executed or disputed in good faith within a particular time period, tenant will be deemed to have confirmed the relevant facts. This provides a landlord with an efficient means to "clear the decks" before entering into a lease or other transaction that could otherwise lead to an argument that another tenant's ROFO was breached.

In conclusion, ROFOs have become a fact of life for many office landlords. Through some tight drafting and forward thinking, the landlord should be able to agree on its ROFO provision that provides the tenant with expansion potential without overly restricting the landlord's ability to manage and expand its relationships with other building occupants. ■

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[1] Conversely, if you are negotiating a ROFO provision for Tenant A , you want to make clear that the "one-time" limitation applies to each block of space or suite on the 6th floor that becomes available pursuant to the

ROFO, and is not completely extinguished as to ***all*** 6th floor suites when Tenant A passed on the first 6th floor suite that was eventually leased by Tenant B.

[2] There are many reasons why Landlord might be interested in accommodating Tenant D without risking that Tenant C exercises its ROFO to Tenant D's space. Tenant D may have higher rent than Tenant C. Or Tenant D may have space elsewhere in the Building, and keeping Tenant D satisfied may be more important to landlord than satisfying Tenant C. Or, perhaps Tenant D is interested in a new short term extension while considering a longer, more significant extension that is accretive to the landlord.

Maryland Effectively Does Away With IDOTs

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In Maryland, IDOTs have been used historically to defer the payment of recordation taxes that otherwise would have been due and payable had a lender and a borrower entered into a financing arrangement secured by a conventional deed of trust. As a result of 2012 and 2013 legislation, Maryland effectively has eliminated the benefit of IDOTs in commercial transactions except for loans not exceeding $3,000,000.

In an IDOT (Indemnity Deed of Trust) structure, there are two obligor parties to a loan: a borrower, who is directly liable under the promissory note, and a guarantor, who guarantees the payment obligations of the borrower and secures its guaranty with a deed of trust on the secured property. Pursuant to an IDOT guaranty, the guarantor becomes directly liable for payment of the loan upon the borrower's default. Based on a long-standing reading of the Maryland Code by the Office of the Maryland State Attorney General, an IDOT has been found to secure a contingent guaranty obligation (i.e., arising as a result of the borrower's default) rather than a direct debt obligation. Therefore, in most Maryland counties, the obligation to pay recordation tax on a recorded IDOT has been deferred until such time, if ever, that the contingent debt payment obligation under the guaranty was triggered (e.g., upon a borrower default). In Maryland, certain transactions also give rise to state and county transfer taxes, and although the effect of these taxes should be considered, transfer taxes are outside of the scope of this article.

Commencing on July 1, 2012, IDOTs securing a debt obligation in excess of $1,000,000 became subject to recordation tax at the time of recordation in the same manner as conventional deeds of trust. This major change in the tax law had a significant impact on the cost of financing commercial real estate in Maryland. For example, in Montgomery County, Maryland, the legislation increased the cost to enter into a commercial real estate secured loan over $1,000,000 by approximately one percent (1%). The law effectuating this major change, however, spawned many new issues relating to existing IDOTs, including the application of taxes in connection with the refinancing of existing IDOTs, and/or the amendment of IDOTs. In response to concerns raised by the real estate community, the Maryland General Assembly amended the Maryland recordation statute.

Commencing on July 1, 2013, IDOTs securing loans in the amount of $3,000,000 or more are treated the same as conventional deeds of trust in Maryland; that is, the loans are subject to the recordation tax. However, it is now clear that the tax deferral for existing IDOTs has been preserved (even if the recordation tax was not previously paid), and existing IDOTs may be modified without incurring a recordation tax, including modifications that eliminate the IDOT structure in favor of a conventional mortgage loan structure. Also, it is clear that an existing IDOT that is supplemented or modified to secure amounts greater than the original indebtedness guaranteed by the grantor of the original IDOT, results in a recordation tax (at the regular rate) only on the additional money secured by the IDOT. Finally, so long as the grantor (or the controlling interest in the grantor) has not changed, a loan secured by an IDOT which is refinanced is subject to the recordation tax (at the regular rate) only on the additional money secured by the new deed of trust.

In short, for new loans, there is no longer a recordation tax savings related to the IDOT structure securing loans at and above the $3,000,000 threshold since IDOTs are taxable to the same extent as conventional deeds of trust. Because existing IDOTs can be refinanced using conventional mortgage documentation and because the acquisition of existing IDOT loan documents is no longer required to avoid recordation tax payment, the increased costs and complication of the IDOT structure are no longer justified. ■

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