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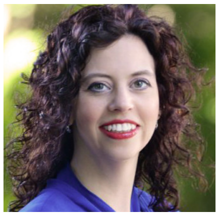
CHANGE IS HARD, BUT HOLDING OVER IS HARDER: TURNING OVER CONTROL OF A COMMUNITY ASSOCIATION (WITH FORMS)



AMY H. BRAY is an attorney with Coulter & Sierra, LLC, in Atlanta. She focuses her practice on community association law, specifically drafting the governing documents for residential and commercial community associations, including mixed use, "green," and age-restricted community documents. She has experience in negotiating and resolving complex covenant and easement issues in developments all over Georgia and throughout the country. She is also a certified mediator and has been brought in to help resolve ongoing litigation involving real estate and community association issues.

Amy is one of approximately 175 members of the prestigious College of Community Association Lawyers. From 2013–2020 she was awarded the distinction of Georgia SuperLawyer. In 2007 and 2009 through 2012 she was named a Georgia SuperLawyer "Rising Star." She is a Fellow of the American Bar Foundation and a member of the Editorial Board of The Practical Real Estate Lawyer.

In theory, turning over control of a community association from the developer to the homeowners should be relatively easy. The governing documents advise when transition occurs, the date arrives, and then the developer delivers a bunch of documents to the homeowners and exits, stage left. But that's not the way it necessarily goes, nor is it the best way to handle the transition of control in every situation.

Ideally, the election of the community association's board of directors by the homeowners is the end of a process that began with the sale of the first lot in the development, or to be even more intentional, from the moment the governing documents for the community association were drafted. There are two things you should keep in mind for dealing with transition: preparation and process. These form the foundation of a strong and well-defined exit strategy for the developer.

Focusing on preparation and process can assist one through the transition, and it can help limit serious liability concerns. So why are preparation and process important? Because turning over a community association is almost always the last thing on a developer's mind, until it's time for the election! A developer is often more focused on permits, supply, labor, construction budgets, construction loans, sales, and more, as immediate needs of the business during that time period.

It is possible, too, that in some situations, the homeowners may also resist taking over control for a number of reasons, such as: (i) concerns about the condition of the common areas; (ii) concerns over perceived defects in the community (e.g., lots, drainage, condition of roads, or condition of amenities); and (iii) concerns that arise because of a lack of understanding about how the association works. By preparing for turnover and following a set process, a developer can minimize these problems in transition, and the homeowners can come out of the transition period feeling like they have a well-developed community.

Preparation

As the old saying goes, an ounce of prevention is worth a pound of cure, and in this case an ounce of prevention is worth many pounds of cure. First, understand that transition starts with the first closing of a home in a development. It is at this point that there are suddenly people with rights and duties that are not purely interested in the development of the community for business reasons.

This is why from the start, documentation is very important. The community association is just as much a corporation as any other, which means the laws that apply to other nonprofits apply here, too. For example, a corporate book, along with other important records, must be maintained during the development of the community. This includes documentation of: (i) annual meetings; (ii) resolutions, formal appointments and removal of directors and officers, warranty information, and ownership of any part of common areas; (iii) copies of service contracts; (iv) leases; and (v) financial and tax records.

It is also wise to convey ownership of the common areas, such as open spaces, parks, amenity areas, natural buffers, private roads, and the like, to the community association early on, especially once they have been improved with any intended amenities. A developer might assume that holding on to common areas gives some benefit to them, but that largely is not the case. Rather, conveying common areas cuts off multiple liabilities from the developer related to the property, such as the obligation to pay property taxes. In some jurisdictions, the taxing authority can tax the property as developable, despite its designation on a plat as a common area or amenity, and, therefore, the secondary benefit may be that the tax rate on the property goes down once it is conveyed to the community association.

Another benefit of conveying common areas to the community association early on is providing a bright line for when the common areas are deemed complete. This should specifically be treated as the act that affirms the transfer of the maintenance responsibility of the common areas to the community association. Maintenance of these areas is often a point of contention during the transition of control of a community association. Conveying the common areas as they are completed provides the bright line for the end of the development and improvement of common areas and marks the beginning of regular maintenance, which is the community association's responsibility.

Early conveyance of the common areas further assists a community association with establishing a more accurate picture of the maintenance costs going forward. When this is done earlier in the development (especially in developments governed by a state or federal statute, such as the Interstate Land Sales Full Disclosure Act, which require that the amenities must be completed before selling the lots), this shift helps to establish a realistic budget for the association. Unfortunately, however, when these proactive decisions are not made early on in development, the effects can cascade. It is common that the continued ownership of the common areas by the developer results in the developer using its own labor to maintain the amenities, pay for property taxes, and take other steps they perceive as "helping" the association to keep costs down. But ultimately this help often obscures the real costs of the facilities. When the rush to shift responsibility over to the homeowners right after the sale of the last lots occurs, there is often either a noticeable difference in the level of maintenance, often most evident in landscaping, or an increase in assessments to be paid by owners. This generally causes frustration and anger for the owners. This is because the owners likely cannot understand the costs of the maintenance due to how the "help" has obscured the true costs, and consequently, they may resist the developer's attempts to convey the common areas to the community association.

In addition to the above, it is very important, from the start, to open and keep separate bank accounts for the community association. Association money, such as assessments and fines, should never comingle with the developer or builders' funds, even if the association is subsidized by the developer or builders. This allows for a clean and independent set of financial books to show the homeowners exactly what the expenses and liabilities for the association really are. Again, this is an area where developers often feel that they have been helping an association, as they simply fund things out of their own pocket and may not set up separate accounts until later in the development. This can cause significant problems when trying to shift control of the community association to the homeowners. Under this situation it is simply difficult for the homeowners to be clearly and reliably advised of the liabilities at play for the association and how it affects their own personal assessment obligations. From a homeowner's perspective, it may not look like the developer was helping the association, but instead was hiding information necessary for the association to properly function. This can turn into accusations of commingling funds, conversion, and possibly embezzlement.

During the development period, and the period of developer control of the association, the developer should keep the community in good shape, physically as well as financially and operationally. The developer, or a management company it engages on behalf of the association, should periodically inspect the common areas to anticipate maintenance and keep things in good repair. In addition, the developer should make any necessary repairs or maintenance before transition to the homeowners. Depending on the nature of the repairs and/or maintenance work, it may be something the developer should cover or it may be something that the association, with association funds, should cover. While in control of the association and appointing the board of directors, the decisions to use association funds for maintenance should be well documented to avoid questions during and/or after transition.

Another financial issue that cannot be emphasized enough, a developer should make sure the community association is solvent at turnover and that it has adequate reserves. When determining adequate reserves, they should take into account the extent of amenities, improvements, and common areas that the community association is responsible for. In other words, the reserve could take into anticipated costs of making major, capital repairs to those items in the future. Associations, via their developer-controlled board of directors can obtain reserve studies that lay out a guide for the amounts that should be in these reserves. If this item is not addressed, the developer is at risk that the homeowners will press claims that the community association was significantly underfunded. Claims brought by homeowners for underfunding reserves can be for quite large sums of money, depending upon how extensive, and expensive, the common area improvements are.

It is important to realize that there should be no need for an increase in assessments at turnover. If the community association has been managed in a way that intentionally understands that it is intended to be a separate and independent entity, the budget should be fairly accurate at the point of turnover. Managing these expenses includes making sure that all common area, services, contracts, and permits are in the association's name from the start. This would include light poles, irrigation, and even the professional management of the association, if applicable.

Copies of all as-built plans for common area improvements, as well as copies of final plats for the development, should also be put aside and delivered to the homeowner-elected board of directors at turnover, as records of the community association.

These documents can help a newly homeowner-elected board of directors for a community association because another item often overlooked by developers is the need to create a process for dealing with architectural review, including documentation of review and keeping records of all approvals and disapprovals for the association. This problem can arise when a developer-approved improvement has been installed early in development and the homeowner-controlled board of directors does not want to permit similar structures, such as fences. Often, though, the developer might not understand the value of documenting approvals and simply give owners a simple yes or no over the phone or as they stand on a job site. A failure to document approvals in written form can become problematic once the homeowners control the community association and take up architectural review responsibilities.

When managing a community association, make sure to create and maintain an accurate roster of homeowners, especially for sending turnover notices and to give to the new board of directors, once it is elected. Communication in the time leading up to the transition, or in a difficult economic time that impacts the development negatively, will be incredibly helpful. Often, problems arise from the failure to communicate things that may be of interest to the homeowners. The disconnect is relatively normal and often due to the developer's need to focus on emergent issues. However, keeping an open channel of communication with the homeowners can make the difference between a stressful and adversarial transition of control and one that is smooth and peaceful.

Another item often overlooked prior to turnover is making sure the community association is properly registered and in good standing with the jurisdiction's secretary of state. If the community association is administratively dissolved, it can be burdensome to reinstate it depending upon the situation. Of greater concern to a developer, this oversight may allow parties to bring claims directly against the developer that might have otherwise been absorbed by the association. Keep in mind that from its incorporation, a community association is a nonprofit corporation, a distinct legal entity. For that reason, not only must the registration be kept up to date, the community association is required to hold an annual meeting each year. Often, developers may see the meetings as a burden or not realize that they are required, but failing to hold a meeting can create problems and is really missing an opportunity to leverage the community association's existence for the benefit of the community and the developer. These meetings are an opportunity to share information about the community with homeowners and to engage them in the workings of the community association in a positive way.

Remember, that when dealing with a community association, acting as a director or officer means that the person owes fiduciary duties to the community association. A developer appointee must be sure to act in the community association's interest when acting as an officer or director of the community association. Preparing for transition helps with this because it provides evidence that a developer-appointed director or officer was acting in the community association's interest when wearing the director and/or officer hat. This is one area where liability can arise for the developer when there are no (or poorly) maintained records or when separate accounts are not opened. With no evidence to the contrary, homeowners can more easily frame developer actions as self-serving rather than in the community association's best interest.

Finally, and this is where the preparation of the governing documents is really key, the developer should identify and know which rights will last beyond the turnover of the control of the board to the homeowners. All rights under the governing documents should be considered and allowed to be treated intentionally and independently, as part of an exit strategy. This allows for a developer to give up or retain rights as necessary to account for how the development is wrapping up.

Process

As previously noted, the process begins from the moment a home is purchased, with homeowner orientation and education about the association, how it is operated, and when transition will occur. Each sale is a step closer to the developer's (hopefully successful and peaceful) exit from the community. As time goes by, the transition should be promoted through encouraging homeowners to participate in the governance of the community, by serving on architectural modifications review, finance, or maintenance committees. Even setting up a welcome committee, encouraging existing homeowners to contact new homeowners in the development, is a great way to get homeowners involved and knowledgeable about the community.

These types of activities can help homeowners gain knowledge about the day-to-day affairs of the association. Each community is different, so the problems they face will be different. They also provide a way to give owners a positive role and a way to channel energy that might otherwise become focused on finding problems and creating problems where there might not have been any.

At some point prior to transition, it may be helpful to have the homeowners elect an ad hoc committee, often also called an advisory board. Generally, this happens as much by default as it does at the initiation of the developer. The resulting ad hoc committee and its effect within the community association is often very clearly influenced by which party decides to form it. For a developer, it is usually better to instigate and foster this type of committee than to allow one to grow out of homeowner concerns within the community. Keep in mind, too, that homeowners are generally becoming savvier about community association functions and better equipped to identify and understand problems within association operations.

Depending on the plans for transition, the ad hoc committee can be given a wide variety of helpful duties, specifically including giving substantive recommendations to the developer-controlled board or monitoring the board's activities. Preferably, the ad hoc committee acts at the request of the board to investigate or evaluate aspects of the day-to-day operations of the association. On the other hand, when an ad hoc committee is formed by unhappy homeowners, the committee may become an active voice against the developer (and possibly the builders), which may result in legal bills, expensive repairs, delays in final buildout, and, potentially, injury to the developer and builders' reputations.

This approach of intentionally forming an ad hoc advisory committee can foster involvement from a wide spectrum of homeowners, instead of only the unhappy ones. An ad hoc committee can promote organized and open communications between the developer and the homeowners. In fact, it is best to try to make the committee reflect a diversity of views and backgrounds from the community. This approach is beneficial for developers as it allows homeowner involvement without a loss of control over the association's actions. However, it can additionally alienate homeowners and sour communications with them if the committee's recommendations are simply ignored by the developer.

Sometimes an ad hoc advisory committee can create problems among the homeowners themselves if only certain factions within the community are participating on the committee. With only particular voices represented, some homeowners may feel alienated or bullied by the other homeowners that are taking the lead. For example, the "tennis people" in the community may take the lead at transition and argue for expensive repairs to the courts, including upgrades, and then the "pool people" become unhappy as money and resources are spent to placate the tennis faction. The groups that are left out may feel like they are being ignored and then start coming up with demands of their own. Eventually, the developer may get stuck in between the multiple factions within the community.

Depending on the size of the community, its make-up, and the provisions of its governing documents, the developer might also choose to provide for the election of homeowners to the board of directors prior to turnover. Often this is a choice made at the time the governance documents are drafted. Alternatively, and depending on the provisions of existing documents, the developer might give up a right to appoint a single director so that the homeowners can elect their own candidate to the board. Over time, the developer might give up more seats on the board until it became a minority and then, no longer held any seats. Generally, the latter option is done at specified points in sales of lots and works best in larger communities. A community of around 100 homes, for example, would probably sell too quickly to make this type of transitional board very useful.

Either way, prior to the election at which owners will be able to elect the entire board of directors of the community association, the developer should send out a letter or other notice letting the owners know that the transition is approaching. The letter should outline what needs to be done for the election, set expectations for what happens both at the election, and offering an organizational meeting between the new, homeowner-controlled board and the developer's representatives. This letter would be informational and would precede any formal, legal notice of an annual or special election where an election is held. It may solicit nominations for the board of directors from the homeowners. Following that letter, and any period for nominations, the election meeting notice should be distributed, along with proxies. The intent of this letter is to clearly set expectations for the events that follow, to prevent anxiety among the homeowners that can translate into adversarial positions among the relevant parties.

The election would then be held, followed quickly by an organizational meeting between the newly elected board members and the developer. At this meeting, the developer should be sure to turn over all of the association's records, which include, but might not be limited to, its financial information, plats for the community, contracts in the association's name, and other related documentation. The new board should also review any "quirks" that the community may have and go over regarding the state of the amenities, if applicable.

Another component of such an organizational meeting can be a walk-through of the community by the new board of directors and the developer's representatives, to discuss any open repair or improvement items to be completed. Often, discussions focus on the overall financial health of the community association and any concerns over loans from the developer to the community association that might have been made during the course of the development. Such debts existing on the community association's books can cause disputes at this time, so producing documentation of loans and referencing any legal authorization that the underlying governing documents give for entering into such loans can be key.

At this point, no recurring services should still be in the developer's name. There should also be an adequately funded reserve account ready for administration by the new board, especially if there are significant capital items such as roads or buildings that need to be maintained by the community association going forward. Access to the bank accounts should be signed over to the board. Documentation removing the developer's directors, officers, and registered agent and replacing them with homeowners' representatives should be completed, if necessary. The amenities, if any, should be in good working condition. Note, however, that that does not mean the amenities should be "like new." Amenities only need to be operational and well maintained.

Conclusion

Use preparation and process to help to make transition of developer control to the homeowners as smooth as possible—or at the very least, to help minimize liability exposure for the developer. The attitude with which the transition is approached is also very important. It is vital for both developers and homeowners to listen to each other and not to be defensive. Being defensive has a tendency to shut down communication, preventing actual concerns from being addressed.

Be communicative. Be available. Be open. Doing so creates trust between the parties. Simply providing information about the community association's annual finances and giving basic information about amenities can assure homeowners that the developer is making decisions affecting the community in an above-board manner. Be patient and listen to determine what the problems are and be willing to work with the various parties involved in the community to create solutions.

After the preparation, process, and attitude factors are taken into consideration, it all boils down to a very important truth: the homeowners and the developer have similar interests at the transition of the control of the community association. The homeowners have an interest in being able to knowledgeably and effectively run the community to preserve and enhance the value of their homes and make the community a place where they enjoy living. The developer has an interest in no longer having to run the association, but having the community run as well as or better than it was intended will enhance its value, and thus, the reputation of the developer.

FORM

ANNUAL ASSOCIATION RESPONSIBILITY CHECKLIST

1. Prepare annual budget and compute assessments
   - ❑ Deliver copy of budget and notice of annual assessments to all members.
   - ❑ Check deadlines for delivery of budget in declaration.
2. Prepare annual financial statements
   - ❑ An annual report including the association's balance sheet, income statement, and financial position shall be prepared by an independent public accountant.
   - ❑ Make report available in corporate records before end of association's fiscal year.
3. Meeting of members
   - ❑ Hold first meeting within one year of date of incorporating the association.
   - ❑ Subsequent annual meeting to be held as provided in association by-laws.
4. Board meetings (or written resolutions)
   - ❑ Declarant appoints and replaces directors unilaterally be resolution, if declaration and by-laws grant such rights to declarant. If weighted vote is the method giving declarant control of board, election must be held.
   - ❑ Organizational meeting for each board of directors (appointing officers, adopting budget and approving renewal of service contract, if any) should be held after the annual meeting of members. By-laws should provide for when meeting must be set.
   - ❑ Hold regular board meetings, preferably at least one each quarter or as provided by by-laws.
5. Association records
   - ❑ Maintain permanent, current records of the minutes of all board, committee and member meetings and all waivers of notice of such meetings.
   - ❑ Maintain current and accurate accounting records.
   - ❑ Make list of association members available for inspection at each membership meeting.
6. Annual corporate registration
   - ❑ File annually with the Secretary of State and pay registration fee.
7. Tax return
   - ❑ Make sure association has a Federal tax identification number.
   - ❑ Association files form 1120 or form 1120H with the Internal Revenue Service.
8. Architectural review
   - ❑ Comply with the requirement in declaration for composition of architectural review committee.
   - ❑ Comply uniformly with process, if any, outlined in declaration or set by architectural review committee for all items architectural review committee is given jurisdiction over.
   - ❑ Maintain records of all applications for approval, approvals, and disapprovals, including any related correspondence.

TURNOVER REMINDERS

1. Early activities

- ❑ Put all common property utility services (electric, water, gas, telephone, etc.) in the name of association.
- ❑ Update association record books and accounts.
- ❑ Review all association records to ensure they are up to date.

2. Preparation for turnover

- ❑ Prior to the transition to owner control, an advisory committee of owners representing a cross section of the interests in the community may be appointed to begin review of association records and understand the day to day management of the association.
- ❑ At about three to four months before the turnover date, a notice should be sent to the homeowners by the management agent, if any, advising them of the approaching turnover and what to expect
- ❑ The homeowners meet to elect the new board of directors, often at a special meeting. It is purely a homeowner function, facilitated by the managing agent. This is often referred to as the "turnover meeting."
- ❑ Obtain the names, addresses, and telephone numbers of the board members and the minutes from the election as soon as possible after the meeting.
- ❑ After the election meeting adjourns, the new board should establish officers- a President, Secretary, and Treasurer. Generally, this would occur at a follow board organizational meeting.

3. After the turnover meeting

- ❑ Organizational board meeting should be scheduled as soon as possible with the newly elected homeowner board of directors. This meeting is not open to the general association membership. Attendees should include a former member of the developer-controlled board and management agent, if applicable. The post turnover board meeting is for the sole purpose of discussing association issues. It does not address construction or warranty issues related to individual homes.
- ❑ Review the association's corporate book & records.
- ❑ Review the association's accounts. (Current financial statements, account histories, tax returns, and control of the association's accounts.)
- ❑ Discuss doing a physical review of the community.
- ❑ Review the association's operations.
- ❑ Change the association's registered agent with the secretary of state.
- ❑ In particular, review the association's insurance policies and make sure that the board has the contact information for the insurance agent and any vendors.

TWENTY-TWO QUESTIONS AND ANSWERS ABOUT ORGANIZING AND TRYING INVERSE CONDEMNATION CASES

BRANDEE CASWELL is a Partner at Faegre Drinker Biddle & Reath, LLP, an AmLaw 100 firm, where she leads the real estate litigation practice, including the national eminent domain practice. She leverages litigation and project management expertise to resolve complex, high-value real estate disputes, projects, and matters from real estate development, land use, and finance to urban renewal projects for shopping centers to energy corridor projects. She is an experienced first-chair trial lawyer who has successfully litigated cases in both state and federal court in numerous jurisdictions including Colorado, California, Illinois, Florida, Minnesota, Oklahoma, Texas, and Wyoming. She also has unique expertise in the Colorado Common Interest Ownership Act (CCIOA), tax increment and municipal/special district financing, and certain specialized oil and gas disputes.

Property owners attempting to make beneficial use of their property are routinely confronted by environmental regulations, ordinances, land use regulations, and all manner of "exactions" as they seek land use and development approvals. Property owners also endure physical invasions, nuisances, and public projects abutting their property which can change access or grade and cause flooding or erosion on their land. Compensation might not be required for many of the restrictions placed on the use of private property.[1] But when such government actions create a substantial interference with the possession, use, and enjoyment of private property,[2] and there is no formal taking by the government, the landowner's recourse is an inverse condemnation claim. These are sometimes referred to as de facto takings.[3]

When a governmental entity[4] takes, appropriates, or damages private property, in whole or in part, temporarily or permanently, without following legal procedures and without paying just compensation, the landowner might have a claim for compensation. These are generally known as takings or inverse condemnation claims. Inverse condemnation claims, however, are relatively rare. Successful inverse condemnation claims are even fewer and farther between. Pitfalls abound both substantively and procedurally when attempting to bring an inverse condemnation claim against a governmental entity.

The goal of this article is to help the practitioner successfully assess, organize, and try an inverse condemnation case. Below you will find a guide and process for assessing and organizing inverse condemnation cases, identifying common substantive and procedural pitfalls, and offering strategic insights for successful cases.

ASSESSING INVERSE CONDEMNATION CLAIMS

1. Does your client have an inverse condemnation or takings claim?

The first order of business is assessing whether your client has a cognizable takings claim. Succinctly stated, an inverse condemnation claim arises when a governmental entity takes or appropriates private property without following legal procedures or paying just compensation to the landowner.

Determining whether the governmental entity has followed proper legal procedures and/or paid just compensation is relatively straightforward. If there has been any prior eminent domain proceeding involving your client's property (and you need to inquire directly on this point), that is the first red flag to investigate, as the prior condemnation might be a bar to an inverse condemnation claim.[5]

The much more difficult question is whether there has been a taking or damaging of private property by a governmental entity. Substantive law addressing this question varies at both the state and federal levels. Properties, and the scope of property rights held by landowners, are unique. The economic impact of rules, regulations, nuisances, exactions, and other interferences with property rights can be subjective and the effect on property may be difficult to quantify. A detailed exploration of the thorny and complex substantive legal requirements to establish an inverse condemnation claim in every jurisdiction is far beyond the scope of this article.[6] Instead, this article aims to provide a roadmap of questions the eminent domain practitioner should explore with the potential client who claims their property has been taken or damaged in the absence of any formal condemnation proceeding. The questions, and their importance, have been identified both through experience and a review of hundreds of inverse condemnation cases and summaries.

DETERMINING WHETHER PRIVATE PROPERTY HAS BEEN TAKEN OR DAMAGED IN THE CONSTITUTIONAL SENSE

2. What type of property is it?

"Property" has many different meanings and those meanings have changed over time. It may include "an object, an interest or a relationship."[7] Generally, state law defines what constitutes "property" and whether there is a legally recognized interest in it.[8]

3. Is there a taking or a damaging or both?

Many state constitutions require payment of just compensation for the taking or damaging of private property[9] and the owner might be able to establish the right to compensation in the absence of an actual taking.[10] The U.S. Constitution does not require payment of just compensation for the damaging of property in the absence of an actual taking.[11] Temporary takings can, but do not necessarily always, constitute a compensable taking.[12]

4. Is the cause or source of the taking or damage a physical invasion?

Physical invasions (a physical occupation or appropriation of some or all of the property) are, per se, takings.[13] Government cutting of trees[14] or ground water contamination through the excessive use of toxic chemicals[15] are examples.

5. Is the cause of the taking or damage a moratorium or other generally applicable government regulation interfering with development of the property?

Whether regulatory burdens restricting the use of real property as applied (e.g., historic landmark designations) constitute takings is governed by the Penn Central[16] test. The Penn Central test requires consideration of three factors:

- The economic impact of the regulation on the claimant;
- The extent to which the regulation has interfered with distinct investment-backed expectations; and
- The character of the governmental action.

This test is generally applied to allegedly excessive government regulations that have unduly restricted the use of property. The Penn Central regulatory takings test has been uniformly criticized as difficult and uncertain because it is an "essentially ad hoc, factual inquir[y]."[17] The recent Koontz[18] case (discussed below) removed at least one class of takings claims (adjudicative monetary exactions) out of the Penn Central quagmire. Moratoria or outright prohibitions on development have formed the basis of successful inverse condemnation claims.[19]

6. Is the cause of the damage or taking an exaction or a condition imposed as part of obtaining land use or development approvals for your client's property?

The Nollan[20] and Dolan[21] decisions have historically been the leading authorities the area of adjudicative land use exactions and permit conditions. Under

Nollan, the government's demand for an easement (an exaction) as a condition to granting a development permit without paying compensation was permitted. But the exaction must substantially advance the interest that would have provided a valid basis to deny the permit.[22] Dolan, building on Nollan, held that exactions (here a dedication of land) must be "roughly proportional[] … both in nature and extent to the impact of the proposed development."[23] In the more recent Koontz[24] case, a divided court held the two-part Nollan/Dolan test also applies to the government's demand for a monetary exaction in exchange for a land use approval.

7. Is the cause of the taking or damage a nuisance or interference with the owner's ability to use and enjoy their property caused by another?

Planes flying so low and so frequently over property, causing noise and vibration, may constitute the taking of an avigation easement, depriving the owner of the use and enjoyment of property.[25]

Removal of lateral and/or subsurface support, slides, and related types of damage can be complex. They are treated differently from state to state depending on whether the governmental entity has the same obligations as a private party and whether negligence is a required element to establish liability.

Flooding, if sustained and/or repeatedly caused by defective sewers[26] or changes to waterways, [27] may give rise to an inverse condemnation claim.

8. Is the cause of the taking or damage a special assessment or other governmentally imposed fee on the property?

Special assessments are unique to various states, such as Minnesota. They are typically imposed by governmental entities on landowners who will receive special benefits from a particular project, such as extension of sewers, water lines, or roads. Special assessments are unconstitutional takings if the value of the real property assessed is not increased by as much or more than the amount of the special assessment. Note: the distinction between "adjudicative fees" and "legislative fees" imposed on real property remains a distinction in a takings analysis.[28]

9. Is the cause of the taking or damage a denial of permits or approvals needed to develop the property?

Permit denials must result in a total or near-total diminution in the value of the property to constitute a taking. For example, denial of a permit to fill wetlands resulting in a 99 percent diminution in value constitutes a taking.[29]

10. Is the cause of the taking or damage pre-condemnation activity by the condemnor who has not yet filed a case and might not ever do so?

Condemnors often engage in planning for potential projects years in advance and this planning routinely involves public meetings and discussions. News reporting occurs and both the public and the market become aware of the potential project. Generally, however, these so-called plotting-and-planning activities by the government in anticipation of a project involving private property typically do not amount to a taking.[30] Circumstances of "aggravated delay or untoward activity,"[31] however, can give rise to a claim for inverse condemnation. As the landowner, particularly in the context of commercial uses, these pre-condemnation activities can quickly diminish the value of the property. When the governmental entity encourages tenants to leave, or engages in activities such as conducting harassing inspections and code enforcements, the conduct goes beyond mere plotting and planning and can give rise to a takings claim.

11. If your client has an inverse condemnation claim, is it ripe?

Questions of ripeness abound and confound in the arena of regulatory takings (but now perhaps only in state court, thanks to Knick v. Township of Scott[32]). Until very recently, under the infamous case of Williamson County, "[a] property owner whose property has been taken by a local government has not suffered a violation of his Fifth Amendment rights—and thus cannot bring a federal takings claim in federal court—until a state court has denied his claim for just compensation under state law."[33]

Williamson County allowed states to impose all manner of state and local procedural and administrative prerequisites in bringing an inverse condemnation claim. The rationale was that,

> [T]he owner must afford the state the opportunity to rescind the ordinance or regulation or to exempt the property from the allegedly invalid development restriction once it has been judicially determined that the proposed application of the ordinance to the property will constitute a compensatory taking.[34]

Following Williamson County, a property owner's path to a successful regulatory takings claim was arduous at best as it shifted an unlimited array of state and local administrative procedures and pre-requisites to the owner, including "exhaustion of any available review mechanism."[35] In California, for example, this could mean:

- First, preparing and presenting a development application to force the local agency to apply the ordinance or regulation to the owner's property;
- Second, appealing denial of the development approval;
- Third, seeking a variance;
- Fourth, appealing denial of the variance (exhausting all review process); and
- Fifth, bringing a writ of administrative mandamus to review the final administrative decision.[36]

Knick v. Township of Scott changed everything, dispensing with the Williamson County requirement that owners first exhaust all state and local remedies before bringing a federal takings claim (which notably was almost always barred by res judicata after the landowner went through the state or local process and lost). The Knick majority recognized this "catch 22" for landowners and addressed it headlong, restoring an owner's right to seek relief under the Fifth Amendment. According to the dissenters, Knick "smash[ed] a hundred-plus years of legal rulings to smithereens."[37] Knick has certainly grabbed the attention of eminent domain lawyers, as it opens up a previously inaccessible forum in federal court (where local politics and being "home-towned" are marginal concerns) and provides for the recovery of attorneys' fees.

For example, in Colorado, a potential regulatory takings issue involving oil and gas interests has been percolating for some time. Local communities in Colorado have been trying to ban fracking by oil and gas companies in the Denver-Julesburg Basin for years. First, both a moratorium and an outright ban by two local counties were struck down by the Colorado Supreme Court.[38] The local regulations were preempted by the state statutory regime (the Colorado Oil and Gas Conservation Act). Second, a citizen-led ballot initiative to impose setbacks that would have prohibited nearly all fracking sites from being permitted was then defeated in a state-wide election. Finally, the state legislature and newly-elected governor enacted sweeping changes to the Colorado Oil and Gas Conservation Act. Rulemaking by the current Oil and Gas Commission is underway. If that rulemaking and related actions result in stranded minerals, the owners of those stranded minerals will have the option of pursuing takings claims in federal court and if successful, recovering their attorneys' fees.

12. Is the takings claim timely?

Statutes of limitation can be a trap for the unwary and must be given careful consideration before bringing an inverse condemnation claim.[39] As with any statute of limitations analysis, there are two key questions: (i) what is the applicable limitations period? and (ii) when did the cause of action accrue?

13. What is the applicable statute of limitations?

Proceeding in the United States Court of Federal Claims, the statute of limitations period is six years.[40] Proceeding under Knick, the substantive claim for relief in a federal court action will presumably be 42 U.S.C. section 1983. But there is no statute of limitations contained within the language of section 1983. Section 1983 "requires courts to borrow and apply to all § 1983 claims, the one most analogous state statute of limitations."[41] Some states have specific limitations periods for bringing inverse condemnation claims. Statutes of limitation may vary depending upon the type of governmental action giving rise to the inverse condemnation claim under state law. For example, in California the statute of limitation applicable to inverse condemnation claims arising from Code of Civil Procedure section 338(j), sets a three-year limitations period for an "action to recover for physical damage to private property" under the takings clause of the California Constitution. But Code of Civil Procedure sections 318 and 319 set a five-year limitations period for an action for adverse possession, and that limitations period may apply if the owner cannot show physical damage (i.e., if the owner has a regulatory takings claim). And as little as 90 days may be the limitation period for a regulatory takings claim based upon the denial of a land use permit.[42]

Specific state statutes of limitation for proceedings against the state as opposed to more general limitations periods to recover title or possession of lands may control.[43] Other states may apply general limitations periods, such as the prescriptive time limit for adverse possession.[44] Still other states require a landowner whose property has been taken in the absence of a condemnation action to bring a writ of mandamus, effectively seeking a court order that the governmental entity must commence a condemnation action. Statutes of limitation on bringing mandamus actions vary, and when the limitations period begins to run is often disputed (as it is in ordinary civil cases).

14. When did the cause of action accrue?

Accrual of a takings claim can be just as difficult to ascertain as the applicable limitations period, and the rules vary from jurisdiction to jurisdiction.[45] Generally, accrual occurs when the act that constitutes the taking occurs.[46] But, government actions that are ongoing or the subject of a gradual process present unique problems as they will be decided based on the facts and circumstances of individual cases.[47] Additionally, regulatory takings claims might not accrue until the particular regulation is applied to the property and its economic impact is known.[48]

Some courts have held that the statute of limitations on mandamus actions does not commence until all the events fixing the government's liability have occurred and that the landowner was or should reasonably have been aware of the existence of those events.[49] Generally, if the occupation of property is continuous and permanent as opposed to temporary, it is unlikely that there is a statute of limitations defense available.[50]

Jurisdictional time bars may also exist in the area of land use and permit denials. For example, in Colorado, a landowner has 28 days to challenge a land use denial under state procedural rules. The time period is jurisdictional and cannot be enlarged by agreement of the parties or a court order. Cities also sometimes have additional or different time frames and procedures in their charters or land use code. Now that landowners have the option of proceeding in federal court under Knick and section 1983, it is unclear whether this 28-day time limit will apply to bar a section 1983 claim. But cities will undoubtedly assert the state and/or city charter time limits as a bar if the case is filed outside of those time periods.

ORGANIZING INVERSE CONDEMNATION CASES

After clearing the initial hurdle of assessing whether your client has a timely inverse condemnation claim, you must begin organizing your case.

15. If your client has a timely inverse condemnation claim, what relief does your client want/expect and what relief can you reasonably obtain for your client?

Your assessment of the claim in terms of ripeness and the statute of limitations may dictate whether you bring the claim in a state or federal forum. Nonetheless, you must also assess what type of relief is available to your client, whether that relief aligns with the client's objectives, and whether it is available.

Consider whether you can obtain:

- Non-monetary relief (striking down the regulation or exaction);
- Just compensation;
- Attorneys' fees and costs; and
- Consequential damages (typically not compensable as part of a taking).

Substantive law at the state versus federal level is likely to impact the relief that can be obtained. For example, attorneys' fees and costs are awarded to a successful section 1983 litigant in federal court. Obtaining an award for reimbursement of attorneys' fees in a state court inverse condemnation cases is typically a much more difficult proposition.

16. Do you need a public relations strategy?

In certain contexts, such as urban renewal projects and the passage of regulations or ordinances impacting real property, public opinion and press coverage can and do effect your ability to bring a successful inverse condemnation takings claim. In bringing a takings claim, you are necessarily naming a governmental entity as the defendant. In some instances, that governmental entity, likely through a public process and one or more public votes, will have approved the very action that you are alleging constitutes a taking of your client's property. You may need a public relations strategy if:

- There has been or will be media coverage of the project or regulation;
- Public opinion is a factor (e.g., environmental regulations or urban renewal);
- Your adversary is a body of elected officials who answer to the public as their constituents (e.g., city council);
- Your client suffers adverse impacts based on media coverage of the project (e.g., if they own a business in an urban renewal area declared blighted, sales will decline as the public believes the shopping center is going to be replaced by something else).

Remember, your adversary is unique. In my experience, elected officials and the governmental bodies they are part of (a city council for instance), do not respond to or participate in litigation like private persons or businesses involved in litigation. There are a number of reasons for this:

- First, the elected officials have probably already made one or more public votes supporting the very governmental action you will be alleging is an unconstitutional taking;
- Second, there is typically some pre-existing public support for the government action (a regulation on property use) to which the elected officials are responding; or
- Third, the elected officials may have campaigned publicly in favor of the government action, building a case in the public's mind that the action is needed.

For example, in urban renewal projects, the process preceding any actual condemnation action is typically a long one, beginning with a blight study. However, this process continues to be led not by public outcry over true "urban blight," but rather, local government desire for economic enhancement, typically in the form of increased sales tax and property tax revenues.

Attaching the word "blighted" to a particular property in the mind of the public is problematic for the landowner challenging condemnation of their property. The public may have already been shown a shiny new "lifestyle center" to replace the shopping center and is excited to see that happen. But, as with Kelo, the case theme of a landowner protecting their private property rights can be very compelling.

17. What level of investigation and breadth of evidence do you need?

As you are organizing your case, consider the sources and options available to obtain evidence and information. Your clients are a natural source of information, but some clients are better than others about keeping and/or providing information. There are other resources to consider, as they can be accessed before you file an inverse condemnation case:

- Public records requests. Nearly every state has some form of open records laws. Make use of them before you commence your case as they are unlikely to be a means of discovery during the pendency of your case.
- Google Earth and historical records. The internet has made possible research that was once immensely expensive and/or time consuming. Google Earth Pro allows you to quickly obtain aerial property images by year and sometimes by specific day. So much information has been digitized, you have significant resources available at your desk.

18. Will a judge or jury decide your case?

Whether a taking has occurred is typically, but not always, a question to be resolved by the court.[51] Juries are more likely to be available at the just compensation phase.

19. What is your burden of proof and how can you meet it?

In an inverse condemnation case, the property owner bears the burden of proving a taking has occurred. The scope of this burden may be a preponderance of the evidence or a heavier burden such as the "greater weight of the evidence" test.[52] In Petition of Ramsey,[53] the court held that a landowner's burden of proof in a de facto condemnation action was only that of a preponderance of the evidence. However, the court decided that evidence offered by the landowner showing the proximity of an airport runway to the landowner's property, the frequency of aircraft landings, and the height at which these aircraft pass over the landowner's property, was insufficient to prove an interference with the use and enjoyment of the landowner's property so great as to make out a constitutional taking.

Are there presumptions or inferences that apply? Presumptions and inferences have been created both by statute and case law on a number of issues and elements that may arise in your case.[54] These can be helpful and/or harmful, so identify them early.

Are there other evidentiary burdens to consider? For example, can you show that the governmental entity acted intentionally? Or, can you show that the property taken is for a public use? In some jurisdictions these are additional elements of your inverse condemnation claim. For example, City of Pharr v. Pena,[55] held that to recover damages under inverse condemnation the property owner must establish that the governmental entity intentionally performed certain acts that resulted in a taking of his property for public use.

20. Who will be the "name and face" of your case?

Some clients are better than others in front of judges and juries. Think of Suzanne Kelo and her cute pink house.

21. Are there unique procedural requirements?

In preparing your lawsuit/filings, give special consideration to whether there are unique notice requirements you must meet as a prerequisite. For example, when challenging a state law as an unconstitutional taking, you may need to provide advance notice to the state's attorney general.

22. How will you tell your client's story?

Pleading an inverse condemnation case involves much more than stating one or more substantive claims for relief. Forget notice pleading standards. Use the complaint to tell your client's story. Make it understandable to a regular person to the greatest extent possible. If you do, the reporter who gets a copy of your complaint is much more likely to understand your case and accurately report it in the media.

A few final notes: Expect a motion to dismiss. Your adversary will, almost without exception, seek dismissal of your case based upon one or more procedural defenses. Be prepared. And prepare your client for it. Your unique adversary likely has significant (if not unlimited) resources to defend against your takings claim. The good news is that if you succeed in establishing that a taking or damaging has occurred, the battle can be won. In this practitioner's experience, a monetary settlement (rather than a public trial on just compensation) typically follows a judicial decision finding that a taking has occurred.

Notes

1 See, e.g., J. Sackman, 2 Nichols on Eminent Domain § 5.07.

2 See Griggs v. County of Allegheny, 369 U.S. 84, 88-90 (1962) (holding aircraft landings and approaches create a substantial interference with the landowner's right to possession, use and quiet enjoyment of the land).

3 See J. Sackman 2A Nichols on Eminent Domain § 6.01[15] (discussing types of de facto takings).

4 The term "governmental entity" for purposes of this discussion includes quasi-governmental entities and even private parties who have condemnation powers.

5 See J. Sackman, 7 Nichols on Eminent Domain § G1B.05 (noting damages must be determined "once and for all time" based on the rights the condemnor has acquired, not what the condemnor intends to do or actually does with those rights). See also, Brian High Development, LC v. Brian Head Town, 348 P.3d 1209 (Utah Ct. App. 2015) (prior action brought by developer's predecessor-in-title barred developer's subsequent inverse condemnation claim).

6 For a comprehensive discussion of regulatory takings claims, see J. Sackman 8 Nichols on Eminent Domain § G14E.

7 J. Sackman, 2 Nichols on Eminent Domain, supra, § 5.01.

8 Id.

9 Ala. Const., Art. XII § 235; Alaska Const., Art. I § 18; Ariz. Const., Art. II § 17; Ark. Const., Art. II § 22; Cal. Const., Art. I § 19; Colo. Const., Art. II § 15; Ky. Const., § 13; Miss. Const., Art. III § 17; Mo. Const., Art. I §§ 26, 27; Mont. Const., Art. II § 29; Neb. Const., Art. I § 21; N.M. Const., Art. II § 20; N.D. Const., Art. I § 16; Okla. Const., Art. II § 24; Pa. Const., Art. I § 10; S.D. Const., Art. VI § 13; Tex. Const., Art. I § 17; Utah Const., Art. I § 22; Va. Const., Art. I § 11; Wash. Const., Art. I § 16; W. Va. Const., Art. III § 9; Wyo. Const., Art. 1 §§ 32, 33.

10 See, e.g., Kupster Realty Corp. v. State, 93 Misc. 2d 843, 404 N.Y.S.2d 225 (N.Y. Ct. Cl. 1978) (holding the right to fly aircraft over the claimants' properties within federally defined navigable air space did not include the right to make damage causing noise without liability in inverse condemnation).

11 See Harris v. United States, 205 F.2d 765, 767 (10th Cir. 1953) (holding under the federal constitution "damages to property not taken are compensable only as a consequence of or incidental to an actual taking").

12 J. Sackman, 2A Nichols on Eminent Domain, supra, § 6.01[16].

13 See, e.g., Lorretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) and Lingle v. Chevron U.S.A., Inc., 544 U.S. 528, 537 (2005).

14 Department of Agriculture v. Mid-Florida Growers, 521 So. 2d 101 (Fla. 1988)

15 Schick v. Florida Dep't of Agriculture, 504 So. 2d 1318 (Fla. Dist. Ct. App. 1987)

16 Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978).

17 Koontz v. St. Johns River Water Mgmt. Dist., 133 S. Ct. 2586, 2600 (2013) (Alito, J. dissenting) (citations omitted).

18 Id.

19 See, e.g., Ventures in Property I v. City of Wichita, 594 P.2d 671 (Kan. 1979) (holding that a prohibition on development of land due to possible future use by the State constituted a compensable taking).

20 Nollan v. California Coastal Commission, 483 U.S 825 (1987).

21 Dolan v. City of Tigard, 512 U.S. 374 (1994).

22 483 U.S. at 834, 836-37.

23 512 U.S. at 391

24 Koontz v. St. Johns River Water Mgmt. Dist., 133 S. Ct. 2586 (2013).

25 United States v. Causby, 328 U.S. 256 (1946).

26 See, e.g., Finamore v. Cann, 334 N.E.2d 518 (Ohio Ct. App. 1975).

27 See, e.g., Hubler v. City of Chorpus Christi, 564 S.W.2d 816 (Tex. Civ. Ct. App. 1978) (completed government projects directly causing an increase in surface waters rendering portion of property useless gives rise to partial taking claim). But see Kratzenstein v. Board of County Comm'rs, 674 P.2d 1009 (Colo. Ct. App. 1983) (holding flooding caused by road project which could be remedied by landowner was not a taking).

28 Glen Hanson, "Let's be Reasonable: Why Neither Nollan/Dolan nor Penn Central Should Govern Generally-Applied Legislative Exactions after Koontz," 34 Pace Env. L. Rev 237 (2017) (discussing and differentiating legislative exactions from adjudicative exactions constituting takings).

29 Loveladies Harbor, Inc. v. United States, 28 F.3d 1171 (Fed. Cir. 1994).

30 See, e.g., J.K.S. Realty, LLC v. City of Nashua, 55 A.3d 941, 948-951 (N.H. 2012) (holding that inverse condemnation action was not proper where the condemnor had simply plotted and planned in anticipation of taking land).

31 See, e.g., Clay County Realty Co. v. City of Gladstone, 254 S.W.3d 859 (Mo. 2008) (reversing summary judgment entered in favor of city that declared property blighted but after five years had failed to move forward with condem-

nation, allegedly harassed property owner with inspections and encouraged tenants to vacate).

32 139 S. Ct. 2162 (2019) (overruling the state-litigation requirement in Williamson County and holding that “[a] property owner may bring a taking claims under § 1983 upon the taking of his property without just compensation by a local government”).

33 Id. at 2167 (citing Williamson County Regional Planning Comm’n v. Hamilton Bank of Johnson City, 473 U.S. 172 (1985)).

34 Hensler v. City of Glendale, 876 P.2d 1043, 1051 (Cal. 1994).

35 See id. at 1050.

36 Id.

37 139 S. Ct. at 2183 (Kagan, J. dissenting).

38 See City of Longmont v. Colorado Oil and Gas Association, 369 P.3d 573 (Colo. 2016); City of Fort Collins v. Colorado Oil and Gas Association, 369 P.2d 586 (Colo. 2016).

39 See generally, J. Sackman 2A Nichols on Eminent Domain § 6.03[9][d].

40 Goodrich v. United States, 434 F.3d 1329, 1333-36 (Fed.Cir. 2006).

41 Owens v. Okure, 488 U.S. 240 (1989).

42 Travis v. County of Santa Cruz, 94 P.3d 538, 543-45 (Cal. 2004).

43 See Hike v. State Dep’t of Rds., 899 N.W. 2d 614 (Neb. 2017) (holding two-year specific limitations period applied to inverse condemnation claim against state rather than eight-year limitations period for recovering title or possession to real property, but also that 10-year limitations period applied to inverse condemnation claims against government agencies other than the state).

44 See Ackerman v. Port of Seattle, 348 P.2d (Wash. 1960).

45 Strode v. City of Ashland, 886 N.W. 2d 293, 304, (Neb. 2016).

46 See Ladd v. U.S., 713 F.3d 648 (Fed. Cir. 2013) (holding, that a Fifth Amendment takings claim accrues when the act that constitutes the taking occurs). See also William H. Dann, Jr., et al 54 C.J.S. Limitations of Actions § 237 (2019 update).

47 See, e.g., Hayden v. Board of Comm’rs, 580 P.2d 830 (Colo. App. 1978).

48 See, e.g., Cumberland Farms, Inc. v. Town of Groton, 262 Conn. 45, 808 A.2d 1107 (2002).

49 See State ex rel. Doner v. Zody, 958 N.E.2d 1235 (Ohio 2011).

50 See, e.g., Corsello v. Verison New York, Inc., 967 N.E. 2d 1177 (N.Y. 2012).

51 See, e.g., City of Northglenn v. Grynberg, 846 P.2d 175 (Colo. 1993) (holding court decides whether a taking occurred and jury determines the amount of just compensation to be awarded).

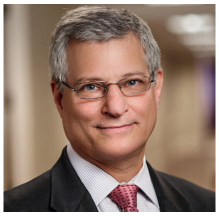
52 J. Sackman, 5 Nichols on Eminent Domain § 18.02[a].

53 Petition of Ramsey, 375 A.2d 886 (Pa. 1977).

54 See J. Sackman 5 Nichols on Eminent Domain, supra, § 18.03.

55 City of Pharr v. Pena, 853 S.W.2d 56 (Tex. Ct. App. 1993).

LEASE CO-TENANCY—A CAUTIONARY TALE



ANDREW R. LUBIN is a principal in the New Haven, Connecticut law firm of Neubert, Pepe & Monteith, P.C. and practices in the areas of real estate and commercial finance. He is an elected Fellow of the American College of Real Estate Lawyers and is the current Connecticut State Chair and a Fellow of the American College of Mortgage Attorneys. He has been included in the national publication, The Best Lawyers in America, and has been named to the Connecticut, New England, and New York Tri-State "Super Lawyer's" lists since their inception. Mr. Lubin serves and had served on several municipal and nonprofit boards and is a frequent lecturer on various real estate-related topics.

To say that the COVID-19 crisis has changed virtually every aspect of life as we knew it is an understatement. Why should leasing be an exception? Even in the pre-COVID-19 days, landlords and tenants could not control uncertainty; but at least they had a somewhat communal understanding of a defined set of market risks and were then able to make rational economic decisions. While the recession of 2008-2009 caused one form of economic peril, COVID-19 has changed the equation entirely. Governmental regulation, executive orders, supply chain disruption, bankruptcy, cataclysmic cash flow issues, and the simple ability to hire or maintain employees have caused parties not only to view new leasing opportunities with caution, but also to dig deeply into their existing lease language.

One of many issues causing alarm in both existing leases and future lease negotiation is tenant co-tenancy. That is, lease provisions that condition a tenant's performance on the current or future occupancy by one or more of the other property tenants.

DEFINING THE ISSUE

Co-tenancy provisions generally fall into two broad categories—opening requirements and operating requirements. As one court has succinctly explained:

> [O]pening cotenancy requirements condition the tenant's obligation to open for business or commence paying minimum rent on satisfaction of the co-tenancy requirement. Operating co-tenancy requirements condition the tenant's obligation to either continue to conduct business or to continue to pay minimum rent on the active operation of certain named tenants and/or at a predetermined level of occupancy within the shopping center.

Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.[1]

A retail tenant (typically one with bargaining power) will often insist on a co-tenancy provision in its lease as a way of protecting itself from the economic consequences of a failed or failing shopping center. By conditioning its tenancy on other tenants operating in the shopping center, a tenant hopes to capitalize on the economic magnet of other tenants to help attract its own customers. A tenant may insist on either a named tenant(s) or certain percentage of space leased to other tenants as a condition to its initial or continued performance. Tenants find these provisions beneficial because if the co-tenancy requirements are not met, they will then typically not be required to open in the first place or, if open, be permitted to pay reduced rent or even terminate the lease altogether.

While a tenant's interest in requiring a co-tenancy provision may be understandable, if not drafted with precision, the result can have dire economic consequences for landlords and their lenders.

JUDICIAL INTERPRETATION

The following cases illustrate some of the arguments used, the judicial analysis, and the pitfalls associated with both poorly conceived and poorly drafted co-tenancy lease provisions. Remember, language matters.

Connecticut

In Kleban Holding Co., LLC v. Ann Taylor Retail, Inc.,[2] Ann Taylor entered a lease for space in a large strip center with a predecessor landlord to Kleban Holding. The lease contained both opening and operating opening co-tenancy clauses that had been negotiated by the parties. The opening co-tenancy provision was not an issue. The operating co-tenancy clause was as follows:

> (b) Operating: In the event Borders, Inc. or fifty percent (50%) of the other retail space in the Center, excluding Tenant, are not open and operating, Tenant shall be entitled to abate Minimum Annual Rent and in lieu thereof pay five percent (5%) of Gross Sales, not to exceed the Minimum Annual Rent otherwise payable in the absence of this paragraph, *until the tenants meeting the foregoing requirements* [emphasis added] are again open and operating.[3]

Borders, after filing for bankruptcy, abandoned its lease in May 2011. In reliance on the co-tenancy operating provision, two months after Borders vacated Ann Taylor commenced paying five percent of gross sales rather than the minimum annual rent.

Kleban brought suit alleging three causes of action: (i) breach of lease; (ii) anticipatory breach; and (iii) unjust enrichment. Ann Taylor had the matter removed to federal court and both parties filed for summary judgment. Kleban's primary position was that the word "tenants" in the operating co-tenancy provision meant that it could replace Borders with any other similar retailer. Ann Taylor argued to the contrary that the lease "unambiguously" permitted the abatement of rent if the named tenant "Borders" were not open and operating.

After discussing the law of contract interpretation and dismissing a string of landlord-offered linguistic interpretations, the court concluded that the lease language was in fact unambiguous. Pursuant to the clause, Kleban only had the right to collect the minimum annual rent if Borders were open and operating:

> [T]he plain language of the Lease dictates that the tenant may pay abated rent until the tenant meeting the foregoing requirement is again open and operating. The only tenant who could fulfill such a request is Borders Inc.[4]

No other tenant or other use could substitute for Borders.

Kleban also argued that the rent abatement would create an $800,000 windfall to Ann Taylor that no reasonable owner would ever have agreed to. In support of this argument, Kleban sought to introduce parol evidence from the president of Kleban's predecessor as well as the predecessor's attorney, who drafted the lease. In depositions, they stated that it was never their intention to preclude a substitute tenant for Borders. Kleban's argument and all extrinsic evidence were rejected because the court found the lease language was unambiguous and, therefore, extrinsic evidence could not be considered as a matter of law.

The court stated that it would not unmake a deal agreed to by two sophisticated parties. Accordingly, Ann Taylor neither breached nor anticipatorily breached the lease. As to Kleban's unjust enrichment claim, the court simply dismissed it, positing that such a cause of action is dependent on the absence of a valid contract. As the lease was valid, there was no unjust enrichment.

If the court's decision was not bad enough for Kleban, there was one final insult to injury. The court awarded Ann Taylor's costs, expenses, and attorneys' fees as the "prevailing party" based upon the attorneys' fee clause in the lease.

Michigan

Another federal district court decision, Sun Valley, Ltd. v. Galyan's Trading Co.,[5] also highlights the danger in identifying specific co-tenants in a co-tenancy clause. This case also dealt with co-tenancy operating requirements.

The defendant tenant, Galyan's Trading Company, entered into a lease with the plaintiff landlord, Sun Valley, Ltd. At the time the lease was signed, there was a Sears Great Indoors store operating at the mall. The co-tenancy clause required that the major anchor store had to be operating in at least 100,000 square feet. The term "major anchor" in this lease specifically meant "a Sears Great Indoors Store containing at least one hundred thousand square feet" of floor area. The Sears Great Indoors store closed and was replaced with a Sears Outlet store.[6] Pursuant to the rent abatement provisions of the clause, the Gaylan's reduced its rent from $84,000 to $23,000 and Sun Valley brought a breach of contract action, alleging that the Sears Outlet store was sufficient to qualify as a major anchor as defined in the lease. The district court disagreed, and in granting Gaylan's motion for judgment stated:

> The lease is clear. Under the lease's terms only a Sears Great Indoors Store triggers the co-tenancy requirement. The Court reads the terms of the lease as the terms appear on the lease's pages. Reading the lease's unambiguous provisions, there is no support that a Sears Outlet Store satisfies the co-tenancy requirements.[7]

The court also rejected Sun Valley's request for relief based on substantial performance. It concluded that the operation of a Sears Great Indoor store was an unambiguous express condition of the co-tenancy requirement. The court was additionally unpersuaded that the doctrine of impracticability applied. Sun Valley argued that because Sears' line of Great Indoor Stores no longer existed, it was impracticable/impossible for Sun Valley to replace it according to the lease's definition of major anchor. The court disagreed, noting that "the fact that the 'Major Anchor' of [the mall] specifically defined as a Sears Great Indoors, would fail, the fact that any business would fail, is foreseeable."[8]

Interestingly, the court noted that the lease failed to include a clause allowing substitution of an "equivalent" tenant. This type of saving language, which a landlord should employ, will be discussed later in this article.

New York

In Staples the Off. Superstore E., Inc. v. Flushing Town Ctr. III L.P.,[9] Flushing Town Center, the landlord, was required as part of an opening co-tenancy provision to lease the premises adjacent to Staples, the tenant, to a "national retailer having not less than 100 stores and occupying not less than 100,000 square feet."[10] As explained in the trial court's decision, Flushing originally intended to rent the neighboring premises to Home Depot, which Staples claimed would have been a "national retailer" pursuant to the lease. See Staples the Off. Superstore E., Inc. v. Flushing Town Ctr. III L.P.[11] Instead, Flushing leased the adjacent premises to BJ's Wholesale Club. Staples terminated the 15-year lease before taking possession, on the ground that BJ's was not a "national retailer." The lease did not contain a definition of "national retailer."

Staples brought an action for judgment declaring that the Flushing failed to satisfy the co-tenancy requirement. The trial court granted summary judgment on the ground that BJ's is not a "national retailer." The Appellate Division affirmed, noting that:

> BJ's is not a national retailer within the meaning of the lease's co-tenancy requirement by its submission of undisputed evidence that BJ's only maintains warehouses in 15 states, principally located along the eastern seaboard and stretching only as far west as Ohio, and does not operate any retail warehouses in the remainder of the United States.[12]

Notably, the trial court rejected Flushing's argument that BJ's could be considered a national retailer despite the fact that it is a Fortune 500 company listed on the New York Stock Exchange with millions of members, and total annual revenues in excess of $10 billion dollars.

This case once again highlights the need for precise drafting. The phrase "national retailer" was used. Had the lease contained some definitional flexibility, perhaps there would have been a different result for Flushing.

Oklahoma

The Tenth Circuit addressed a co-tenancy provision under Oklahoma law in Rockwell Acquisitions, Inc. v. Ross Dress for Less, Inc.[13]. As in Kleban, this case illustrates the consequences of insufficient landlord flexibility in finding substitute tenants.

In Rockwell Acquisitions, the lease co-tenancy operating requirement provision permitted the tenant, Ross, to pay a lower substituted rent if certain named tenants (or permitted substitutes) failed to be part of the center. The landlord, Rockwell, replaced one of the named tenants, Big Lots, with two small tenants, K & G and Famous Footwear, instead of one large anchor tenant as defined by the lease. The court noted:

> To satisfy the co-tenancy provision, Rockwell must fulfill two requirements: (1) all three of the "named" co-tenants—Target, Big Lots, and PetSmart—must be open and operating in the shopping center, and (2) the named co-tenants must occupy at least 90 percent of the specified floor area. If Rockwell does not fulfill these two requirements, it can still satisfy the cotenancy provision by exercising the 'comparable replacement Anchor Tenant' option. The anchor tenant option has three requirements: the tenant must (1) be "a national retailer with at least one hundred (100) stores or a regional retailer with at least seventy-five (75) stores," (2) "replac[e] one (1) or more of the named Co-Tenants," and (3) "occupy[] no less than ninety percent (90%) of the Required Leasable Floor Area of the Required Co-Tenant being replaced. [14]

The district court granted summary judgment for Ross and concluded that because Big Lots, an anchor tenant, was not operating, Ross was entitled to pay the lower substituted rent. It did not matter that the Landlord filled Big Lots' store space with two smaller tenants because "the lease's co-tenancy provision required Rockwell to replace Big Lots with one anchor tenant occupying at least 90 percent of Big Lots' space. Rockwell did not do so, and therefore it breached the lease agreement."[15]

Once again, this case illustrates that a court will often give a literal interpretation to the plain language of the lease.

California

Best Buy Stores. L.P. v Manteca Lifestyle Ctr., LLC,[16] also demonstrates the consequences of inexact language.

Best Buy entered into a lease with Manteca Lifestyle Center, LLC, which was in the process of developing a shopping center. The lease provided that two of the following businesses had to be open: J.C. Penney, Bass Pro, and a cinema. The lease also contained an attached site plan that stated that the shopping center would eventually have a total square footage of 743,908 square feet. At the time the parties signed the lease, approximately 373,000 square feet had been constructed. At issue was the portion of the co-tenancy clause that stated:

> Tenant shall not be required to open for business unless sixty percent (60%) (not including Best Buy) of the gross leasable area of the Shopping Center are open and operating at the Shopping Center . . . including at least two (2) or more of the following tenants (I) J.C. Penny; (ii) Bass pro; (iii) a cinema.
>
> Should the Co-Tenancy Condition not be satisfied, Tenant may either (i) delay opening for business until the Opening Co-Tenancy Condition is satisfied . . . or (ii) open for business and pay fifty percent (50%) of the monthly Rent (and any additional other costs without reduction) payable pursuant to the terms of this Lease until such time as the Opening Co-Tenancy Condition has been satisfied. [17]

Initially, the other co-tenants were not open. Best Buy reached a point at which it could no longer delay opening, so it elected to open and pay reduced rent. By the time the rent came due, the cinema and Bass Pro were open. J.C. Penney opened shortly after. Manteca demanded payment of full rent, claiming that with those three tenants approximately 78 percent of the available space (373,000 sq. feet) had been leased. Best Buy, however, claimed that "gross leasable area" referred to the total amount contained in the Site Plan (743,908 sq. feet). Best Buy brought a breach of contract/declaratory judgment action. Manteca moved for summary judgment, which the court denied. The court concluded that there was a genuine issue of material fact as to the proper definition of gross leasable area. The court concluded it could mean the total amount of space completed at the time of the lease, as Manteca claimed, or it could mean the total amount of the space contained in the site plan, which was attached to the lease.[18]

Once again, drafting inconsistency led to lease interpretation uncertainly and litigation.

By interesting contrast to the cases above, Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.,[19] also dealt with opening and operating co-tenancy provisions with the landlord, Grand Prospect, faring somewhat better. The lease at issue conditioned the opening of the Ross's store and the payment of rent on another major tenant (Mervyn's) being open. Before Ross's opening date, Mervyn's filed for bankruptcy. Ross neither opened nor paid rent. A further provision allowed Ross to terminate the lease if the co-tenancy failure continued for 12 months. After 12 months Ross elected to terminate the lease. Grand Prospect then sued, but, unlike the landlord in Kleban, it argued explicitly that the co-tenancy provisions were unenforceable as both unconscionable and a penalty. The trial court agreed and, after a jury trial, awarded substantial damages.

On appeal, the California Appellate Court reversed the decision after analyzing the rent abatement and termination provisions separately. As to the termination, the court determined that California had developed a specific rule that applies to lease termination clauses. It held specifically that the termination provision was not a penalty (nor a forfeiture) as it was agreed upon by sophisticated parties and Mervyns's act (bankruptcy) had no relation to any act or default by either of the parties. Furthermore, this rule of law superseded the law applicable to the analysis of whether the termination provision constituted a penalty.

The rental co-tenancy provision, however, was a different matter. Relying on existing California precedent, the court found that unlike termination provisions, California law required an analysis of whether the rent abatement provision bore any reasonable relationship to the harm anticipated by the tenant. If no reasonable relationship existed, it would be an unenforceable penalty. Since the record disclosed that Ross did not actually anticipate suffering any harm as a result of Mervyn's closure, the rent provision was held unenforceable due to the lack of any reasonable relationship to the anticipated harm to be suffered. However, because the lease termination provision was held to be enforceable, the court awarded Grand Prospect one year of rent as damages plus attorneys' fees. Had there not been a termination provision, it seems likely that the appellate court would have sustained the original trial court holding of substantial damages.

Despite its holding, even the court may have been concerned with the breadth of its decision. In the opinion's opening lines, it states:

> This opinion does not establish a categorical rule of law holding co-tenancy provisions always, or never, enforceable. Instead, it illustrates that the determination whether a co-tenancy provision is unconscionable or an unreasonable penalty depends heavily on the facts proven in a particular case.

POSSIBLE DRAFTING SOLUTIONS

As illustrated by these cases, co-tenancy provisions can have unpredictable and potentially disastrous consequences. The Kleban court appears to have summarized the prevailing attitude of courts in interpreting co-tenancy provisions: "courts do not unmake bargains unwisely made."

From the landlord's perspective, it might be easy to conclude that co-tenancy clauses should be avoided altogether. Unfortunately, market considerations often mandate that a landlord concede the issue in order to attract "appropriate" new tenants who may be unwilling to take a risk in a new (or weak) shopping center without such a provision. Assuming that they cannot be avoided, there certainly are considerations that can be employed to help minimize the adverse financial impact of a co-tenancy clause and prevent litigation, while at the same time remaining fair to both parties. While not exhaustive, some of these considerations are as follows:

- A landlord should avoid the use of specific store name reference to co-tenants at all costs. Generic, descriptive, or "equivalent" tenant replacements should be used.
- Rent reductions or abatements should be limited to a specified time period. At the end of the time period the tenant should be required to elect to either: (i) resume paying the normal lease rent; or (ii) terminate the lease. A landlord could also reserve for itself the option for early termination if the tenant exercises its rights under an abatement provision. A lease should also specify that any rent reduction should be the tenant's exclusive remedy for any co-tenancy violation.
- Based on the holding in Grand Prospect Partners, it would seem desirable to have an acknowledged relationship between the anticipated loss to the tenant and the value of the rent abatement. A landlord could also require the tenant to demonstrate actual proof of loss as a result of the co-tenancy violation (i.e., drop in revenue) before a tenant is able to take advantage of the provision.
- The lease should provide for liberal landlord cure rights before the co-tenancy provisions can be invoked and that co-tenancy rights cannot be exercised if the tenant is in default.
- In the event of a lease assignment, the co-tenancy provisions should not be exercisable by the assignee.
- Rent reduction should not apply to any tenant improvements advanced by the landlord. If early termination, a tenant should be required to reimburse the landlord for any tenant improvements paid for by the landlord.

CONCLUSION

By their nature, lease co-tenancy provisions deal with uncertain future events over which the parties may have little control. The effects of COVID-19, market downsizing, store closings and mergers have been felt in many markets and more are on the horizon. The cases provide modern-day reinforcement for the proposition that careful attention to language should be at a premium. The draftsperson must take great care in attempting to bring certainty into an unpredictable arena.

Notes

1 Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc. , 182 Cal. Rptr. 3d 235, 244 (Cal. Ct. App. 2015), modified No. F067327, 2015 Cal. App. LEXIS 130 (Cal. Ct. App. Feb. 9, 2015).

2 Kleban Holding Co., LLC v. Ann Taylor Retail, Inc. , No. 3:11-CV-01879 (VLB), 2013 U.S. Dist. LEXIS 168231 (D. Conn. Nov. 26, 2013).

3 Id. at *3-*4.

4 Id. at *20.

5 Sun Valley, Ltd. v. Galyan's Trading Co., LLC, No. 13-13641, 2014 U.S. Dist. LEXIS 34103 (E.D. Mich. Mar. 17, 2014).

6 Id. at *3.

7 Id. at *11-12.

8 Id. at *27.

9 Staples the Off. Superstore E., Inc. v. Flushing Town Ctr. III L.P., 933 N.Y.S.2d 732 (N.Y. App. Div. 2011), lv. denied, 982 N.E.2d 619 (N.Y. 2012).

10 Id. at 734

11 See Staples the Off. Superstore E., Inc. v. Flushing Town Ctr. III L.P., 926 N.Y.S.2d 347, 30 Misc. 3d 1239 (N.Y. Sup. Ct. Feb. 28, 2011).

12 Staples, supra, 933 N.Y.S. at 735.

13 Rockwell Acquisitions, Inc. v. Ross Dress for Less, Inc., 397 Fed. Appx. 424 (10th Cir. 2010).

14 Id. at 427.

15 Id. at 428.

16 Best Buy Stores. L.P. v Manteca Lifestyle Ctr., LLC, 859 F. Supp. 2d 1138 (E.D. Cal. 2012).

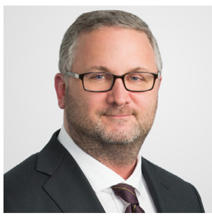
17 Id. at 1143.

18 Id. at 1148.

19 Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc., 182 Cal. Rptr. 3d 235 (Cal. Ct. App. 2015), modified No. F067327, 2015 Cal. App. LEXIS 130 (Cal. Ct. App. Feb. 9, 2015).

COMMERCIAL REAL ESTATE FINANCE AND COVID-19

RICHARD FAVATA is a Partner at Cassin & Cassin LLP, in New York. He represents institutional lenders, private banks, private equity funds, investment banks, corporations, property owners, developers, and governmental entities with respect to CMBS and balance sheet financings, acquisitions and dispositions, leasing and sale-leaseback transactions, and joint venture arrangements. Additionally, Mr. Favata has extensive experience representing financial institutions, private equity funds, and hedge funds in the restructuring and work-out of real estate transactions. Prior to joining Cassin, Mr. Favata practiced at Skadden, Arps, Slate, Meagher & Flom; Hughes, Hubbard & Reed; and Luskin, Stern & Eisler.



BRET R. SALZER is a Partner at Cassin & Cassin LLP, in New York. He has more than 20 years of experience in executing complex real estate acquisitions, financings, joint ventures, and other development and operating agreements, preferred equity transactions, fund investments, buyouts, and dispositions. Mr. Salzer represents investment banks, asset-based lenders, private equity funds and developers, as outside counsel. In addition, he has acted as in-house counsel to leading real estate developers and operators. In both capacities, Mr. Salzer has conducted numerous mortgage and mezzanine loan originations, acquisitions, dispositions, participations, restructurings, and workouts covering term, bridge, construction, and other financings of every real estate asset class, as well as other corporate, fund, and asset-level loan facilities.

This article aims to articulate some of the ways the commercial real estate finance industry (CREF) has been impacted by the COVID-19 pandemic from the practical real estate lawyer's perspective—and to look a little way down the road ahead.

COVID-19 has brought two major commercial real estate (CRE) sectors—hospitality and brick-and-mortar (B&M) retail—to crossroads so far, pushing CREF principals and professionals to "play defense" while searching out risk-tolerable ways to revert to "playing offense" as opportunities emerge.

The sudden steep decline in traveler and B&M consumer activity, and uncertain prospects for its resumption, had the most radical immediate impact on hotels, which had generally been doing well pre-COVID-19. B&M retailers were similarly brought to a standstill—but had not been doing so well pre-COVID-19.

As a result, the hotel industry is expected to essentially bounce back from COVID-19, whereas in many ways COVID-19 is acting to accelerate B&M's plunge to the bottom. This simple up-market versus down-market distinction in the ways these two sectors' underlying secular trends interacted with COVID-19 drives the thinking of CREF principals as they play both offense and defense, in ways that will shape the practical real estate lawyer's agenda for years to come.

UPDATING THE CONVENTIONAL WISDOM ON "DEFENSE"

What do we mean by "offense" and "defense"? CREF is intended to be about investing capital in assets to provide value to users and produce returns for investors. In good times, that is the whole business. In downturns, that primary activity gets relabeled as "playing offense" and "playing defense" refers to the ways investors and asset managers shift gears away from searching out, vetting, and executing on new investment opportunities, to focus instead on protecting existing portfolios from harm or at least mitigating it.

From the lender's perspective, there's a conventional wisdom of playing defense (which we'll call "CW," since we use it a lot)—a set of generally accepted outlooks, practices, and protocols that CREF professionals have typically used to frame and guide their approach to protecting portfolios in down markets. Following is a survey of some of the keystones of defensive CW, and how they're being adapted in real time to meet the COVID-19 challenge.

Loan collateral value

A key premise of defensive CREF CW is that in order to determine a course of action, a lender must develop as fully informed and astute an understanding of the loan collateral's market value as possible. This is often difficult to do in times of economic dislocation, since real estate is thinly traded and therefore relatively illiquid—every asset is unique and often can be put to effective use by just a select few players in the relevant market, so there can be no broadly traded exchange to mark individual asset pricing to market daily pricing, such as we do have with the stock market.

All this being the case, when downturns do occur owners tend to develop a fondness for their pre-crisis opinions of value, and it often takes a long time for them to be forced to capitulate to a reset at the lower "new normal" price levels willing buyers will pay. As we are in the early innings, it's too soon to find the new normal market price of many hotel and retail properties.

But despite the difficulties, lenders on defense need to arrive at a conviction about value and pricing as a baseline sooner rather than later and before trying to underwrite any given borrower's "roadmap back to normal" business plan and determine the risks and rewards of any proposed loan workout based on that business plan.

That need is front-and-center because in times of stress, any given CRE asset's value determines the degree to which the existing capital stack is impaired.

And that's essential because the identity of the party or parties who are still "in the money" and those who are "out of the money" in turn says a lot about the various parties' incentives to act—whether cooperatively or not—or simply to give up. It often also results directly or indirectly in changes to the respective parties' contractual rights and powers vis-a-vis one another.

For this reason, a lender's view on valuation now and going forward is the foundation of any effort to evaluate how its position and fortunes are likely to change going forward if it does (or does not) agree to any particular sponsor-proposed loan workout or restructuring, which in turn is based on the sponsor's overall proposed operational and financial roadmap back to normal.

In ordinary times, valuation is routinely established by obtaining an appraisal of the property. In the COVID-19 era to date, the utility of appraisals has been compromised. For the past several months, there has effectively been no market price for many CRE assets, particularly those in the hotel and B&M retail sectors. As of the time of this writing (July 2020), most would-be sellers in those sectors simply cannot find buyers at any price they would accept, and that state of play will continue for an unpredictable period of so-called price discovery, ending when buyer or seller price capitulation finally closes the bid-ask spread.

Ultimately, sellers and therefore appraisers can't put an income rebound pin in the calendar until there is a medical and policy solution to COVID-19 and consumers are again willing and able to use hotels and B&M retail at something like their respective full capacities. Only when "new normal" occupancy and rental benchmarks are set in the use market will those property revenues support asset values that buyers can rely on to buy and (our focus) that lenders can underwrite to underpin a workout (or pursue a foreclosure, deed in lieu, or loan sale strategy).

In short, a third-party report of valuation that both parties to a transaction would subscribe to simply may not be in the cards today—and to that extent we do not have a functioning market. CREF principals and professionals are left to formulate their valuation theses based in some ways less on their understanding of the subject property's specific characteristics, and more on generalizations they venture to make about the asset subclass the property falls within. This is because COVID-19 has had such distinct and specific effects on the various subclasses within the broader hotel and B&M retail sectors, as we touch on below.

Collateral condition

A related pillar of downcycle CREF CW stresses the importance of obtaining a structural engineer's property condition report (PCR) and an environmental site assessment (ESA) of the subject property before commencing a loan workout or restructuring.

The idea here is simply to uncover issues with the property and require the sponsor either to immediately address them or else set up cash reserves to do so. Environmental or structural problems that have arisen since the original loan closing, when similar reports were last obtained by the lender, will also have to be addressed. This is important because any deterioration in the property's physical condition can reduce the collateral's value, and any new environmental problems could also subject the lender (and any successor in title) to liability exposure—the bane of lenders everywhere.

But COVID-19-driven stop-work orders initially made third-party reports harder or impossible to obtain, and a pervasive COVID-19-driven attitude that "we're all in the same boat" incentivized lenders not to require them in the initial round of forbearance negotiations (discussed below) even though they soon became generally available quickly and cheaply due to low demand.

Relatedly, many or most of the forbearance arrangements entered in round one of the COVID-19 downturn decimated the very same loan reserves that would otherwise be available as a first-line defense against unexpected collateral condition issues. Those reserves were (sensibly enough under the circumstances) recruited from those lower-priority uses in order to bridge for current revenue shortfalls and to pay debt service and other high-priority operating expenses like ground rent or taxes.

That decision, however common and understandable, nevertheless lowered the collateral's defense at the very same time when asset deterioration risk was on the rise, as it will with "dark" assets. As a result, lenders that have not yet done so should strongly consider making a PCR and ESA an early topic of the conversations about "round two."

If the reports disclose issues, the lender should consider requiring fresh cash from the sponsor or its sources, both to fix what needs fixing and to top up reserves for the future.

Deal hygiene

CREF CW is full of chestnuts that fall under the rubric of what we might call "deal hygiene"—best practice precepts that serve as metaphorical PPE for the health and safety of the lender as it considers and then negotiates a loan workout or restructuring. Among these nuggets of wisdom:

- "Maintain one point of contact with the borrower";
- "Make no promises or assurances, written or oral and disclaim the same in written communications";
- "Emails are binding"; and
- (Most of all) "Do not proceed without a well-crafted pre-negotiation agreement."

You could even sum these up as "First, do no harm" if pressed for time.

Here, once again, generally prevalent cooperative attitudes characterizing the COVID-19 era may have led some lenders to let down their guard on this front—but COVID-19 is going to be a long haul and that mandates discipline. Lenders and borrowers inhabit different niches in the CREF ecosystem, and there's no use pretending that they are partners. Certain formalities must be maintained with all the punctiliousness of high tea with the queen—and COVID-19 underlines rather than supersedes that advice.

Here's another old CREF CW nugget: at the first sign of distress, lenders should vet their loan documents carefully, and where they are broken, fix them while they have the borrower's attention. This should be a condition to granting the borrower's initial forbearance request—the risk is losing the leverage necessary to do so later, when it's time to do a more substantive loan modification, or even to begin pursuing remedies. Along related lines, CREF CW tells lenders to confirm their lien perfection and priority (via a title search) and, once again, to fix whatever is broken in those regards early on—because a stitch in time saves nine.

On both these fronts, here's the COVID-19 update: COVID-19 gave lenders a clear opportunity to do these things, but given the fact COVID-19 was preceded largely by blue-sky market conditions and responsible borrower behavior, not to mention the COVID-19-driven "we're in this together" mentality, some lenders may have glossed over this opportunity and should strongly consider making it part of the ticket to admission to any talks about round two.

Other lead-time "stitch in time"-type activities for hotel lenders in particular to focus on during the pendency of round one include assessing and addressing:

- Any CBA successor liability risk;
- Operating and liquor license term and transferability; and
- Comfort letter reliability in both a workout and foreclosure or deed-in-lieu context.

Cash management/Cash flow position and reserves

Another bit of down-cycle CW speaks to the importance of confirming early on in the workout process:

- Whether the lender's cash management rights under the documents are what it expects them to be;
- Whether those rights are being respected and observed in practice; and
- Whether the lender wants to trigger any available lockbox, cash management waterfall and/or excess cash trap rights.

In this regard, given the impact of COVID-19, it's a hard truth that these cash management tools have about as much utility as pushing a rope uphill when there's simply no cash coming into the system. Cash management is about disciplining borrower behavior, which, while it may be the reason for some downturns, is not to blame for COVID-19. As such, applying and beefing up cash management protocols is less of a factor in playing defense in the current downturn than in prior ones. (That's obviously a broad generalization and as they say, every real estate deal is unique.)

Along similar lines, CREF CW tells lenders to consider requiring more frequent and/or more detailed financial reporting as a condition to any initial forbearance, in order to confirm that the property's cash flow and reserve positions are as expected and as the lender needs them to be in order for any subsequently proposed loan restructuring, succession to title, and/or discounted payoff to make sense and work economically.

The COVID-19 update to this, however, is that property-level reporting tells you more about how bad things have gotten and whether a recovery has begun, and less about how fast and how completely things will get better going forward. In a COVID-19 world, that depends on externalities (medical and policy solutions that allow consumer behavior to resume), which are best "underwritten" (as a guesstimate) by sub-asset class.

Another CW standby is that lenders should confirm early and often whether the borrower (and/or any property manager or hotel manager) has been using cash in a sensible and honest way.

The COVID-19 lesson here is that a presumption of innocence may have led some lenders to honor this precept in the breach in round one. That will come back to bite some. To avoid being bitten, lenders should give their borrowers a real vetting before round two.

Sponsor quality

Last, but in no way least, CREF CW counsels lenders to get a good strong handle on sponsor commitment, capability, and wherewithal before moving down any road to restructuring. A savvy lender studies each borrower-side constituency and how each might behave because (for example) anyone with skin in the game can step up with new money to support a workout. Is there a credible, capable operator with a track record through both up and down cycles? Are the sponsors "good guys"—cooperative, honest, and so on? These are essential questions, and never more so than in the context of COVID-19 which has created a truly daunting asset management exercise. Here the CW is once more proven roadworthy.

Summing up the guidance on CREF CW in the COVID-19 era: Prior to the end of any round one forbearance period, lenders should do a cost-benefit analysis of all these best practices, make decisions about whether it's timely to act on them, and inform sponsors that further forbearance and/or loan modification requests will be conditioned on adherence to those decisions.

PLAYING DEFENSE: MARKET CONDITIONS AND THEIR DISRUPTION

As we all know, COVID-19 came more or less out of the proverbial clear blue sky. One day we were plugging along, enjoying pacific economic conditions. The next, we were told to go home and shelter through a pandemic. There was no lengthy buildup of economic causes for concern preceding the main event, in marked contrast to the rocky 18-month road to the 2008-vintage global financial crisis (GFC).

As such, borrowers and properties in the aggregate (to say nothing of lenders) are much more conservatively leveraged than they were going into the GFC—far more owners can come out-of-pocket to bridge the COVID-19-driven revenue disruption than could right their capital stacks by paying off excess debt out-of-pocket 10 years ago.

As a result, capital structures may have been badly bent by COVID-19, but so far only a limited number of them are truly broken (e.g., via margin calls on mortgage REITs and debt funds)—distress so far is liquidity-driven rather than real estate fundamentals-driven. (By "broken" we mean that some degree of irretrievable investment value loss is occasioned by the structure's lack of flexibility to accommodate bad news—in other words, a fire sale of some kind occurs.)

Playing defense: early phases

Given that COVID-19 hit everyone at once, through no fault of borrowers and for an unknown duration, many borrowers initially approached lenders with kitchen-sink forbearance or loan restructuring requests that reflected their own state of shock more than anything else. Lenders' negative feedback educated borrowers to the need to tailor proposals to a coherent new business plan as a route back to stabilization.

Since that kind of planning hasn't happened yet, there has been a phase of kicking the can. When planning once again becomes possible, lenders and borrowers can start to craft more substantive responses. If the lender has agreed to a full-blown loan restructuring based on a fleshed-out and lender-approved roadmap to recovery, the sponsor is almost certainly contributing capital or obtaining some fresh equity from outside sources. When no viable loan modification is workable, we will see more foreclosures, deeds in lieu, discounted payoffs, and loan sales.

In addition to cash infusions, modifications may be tied to conditions precedent such as:

- New debt service reserves;
- Leasing, occupancy, or other performance deadlines;
- New guaranties, guarantors or bad acts;
- A new equity pledge (pitting the fear of clogging against fear of a four-year mortgage foreclosure); and/or
- A "deed in the box" or consent to foreclosure.

Of course, the lending business is an ecosystem unto itself, with its commercial mortgage-backed securities (CMBS) industry, investor-driven alternative lenders of various stripes, debt fund, and relationship-based lenders, each specialized to fit a niche. These differences drive very differing workout capacities that are having major effects on borrowers, a topic for another article.

PLAYING OFFENSE

CREF decisionmakers looking to deploy capital in new debt originations have a lot to think about these days. There are the public health and policy questions that go into handicapping a second wave. There's the macro "alphabet soup" conversation about whether the recovery will be shaped like a U, V, W, or (heaven forbid) L. There's the fascinating welter of specific ways that COVID-19 affects human behavior and thereby favors drive-to destinations and roadside travelers' hotels over convention center properties or destination resorts these days. And on the retail side, there are similar effects differentiating big omnichannel retailers from B- and C-class suburban malls—and all those tenant bankruptcies, where the courts have acted to accommodate rent delays while going-out-of-business sales could not feasibly occur due to shutdown orders. There really is a lot happening at once, and a lot of uncertainty to contend with.

As alluded to above, all of this is in general keeping bid/ask spreads wide, as between tenants and landlords first, sellers and buyers second, and lenders and borrowers third. Price discovery is ongoing, capitulation still infrequent and patience enduring, but burn rates are hitting owners hard and large pools of investible capital are burning holes in some pockets. Market forces are pushing people closer together and they will transact eventually—and if they manage to do so before all of the COVID-19 uncertainty has been resolved, they will find ways to allocate risks in their contracts.

So we will eventually get back to a reformed and re-stabilized CRE and CREF marketplace with "new normal" price points as to rents, property values and loan pricing. Until then, we will see a series of vulture plays and white-knight activities within the capital stack.

We've already seen the first wave of broken capital structures, starting with interests in mortgage REITS and related securities, along with some loans held by debt funds forced to sell loans in the face of loan remarginings, yielding some opportunities for distress investors.

We've also seen rescue capital plays, and expect to see many more, in the form of new mezzanine and preferred equity investments filling gaps in the capital stack. This can occur in the course of a loan workout, or it can happen to facilitate a mortgage payoff when new mortgage loan proceeds fall short.

Smart investors watch out for adverse selection and try to emulate the tortoise rather than the hare. And in these conditions, that level of prudence keeps the vast liquidity seized up at the moment. Lender reticence continues as cost of capital remains unsure. The result is a shift to a lender's market—lenders are quoting conservative pricing, terms, structure, and credit support for their best clients only on the best deals, with everything else essentially on hold.

On the equity side (whether buying bricks or buying or investing in debt or equity), collections are better than expected which augurs against a tsunami of distressed buying opportunities similar to the RTC crisis or GFC. Today's distress market is about adding mezzanine or preferred class structures within existing capital stacks to bridge revenue drops and/or restock reserves.

Caution: dual-collateral loans

Certain lenders today need to be paying attention to the old common law doctrine that any mortgage borrower has an absolute and non-waivable right to redeem the collateral at any moment up until the very last moment of the mortgage foreclosure process, preventing the loss of its property to the foreclosure sale by paying off the mortgage loan in full. While this right—the so-called equity of redemption—sounds relatively non-controversial on the face of it, the doctrine includes the principle that any agreement which purports to contravene (clog) the equity of redemption is void.

In recent years, there has been a noticeable uptick in so-called dual collateral mortgage loans, in which a mortgage lender will take an equity pledge as additional collateral for its loan at origination. Today, a substantial number of dual-collateral mortgage loans are outstanding, many of them held by debt funds and other alternative lenders in the transitional and bridge loan space. Also, when a mortgage loan is in default, the borrower may sometimes execute an equity pledge as part of a loan workout arrangement.

This structural feature is attractive to the lender in theory, in that it appears to give the lender the flexibility to cut to the chase in its enforcement and recovery process after a loan default. If the prospect of a multiyear judicial mortgage foreclosure slog is unappealing, the lender can simply conduct a non-judicial UCC foreclosure, avoid the court system altogether, and succeed to the ownership in as little as a couple of months.

But each of those dual collateral loans is arguably a trap for the unwary lender. While anti-clogging doctrine is firmly set in place by cases from the days of clipper ships, not a single case squarely addresses the question of whether modern-day dual-collateral mortgage loans or their enforcement are a clog on the equity of redemption. Most lawyers take a conservative view on the subject, at least when asked, but in practice there has been a lot of debt capital extended into the dual-collateral construct.

Lenders who employ this structure may have rationalized along the lines of a statement by a New York court in a 2018 case, HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC,[1] to the seeming effect that the dual-collateral structure and the lender's election to foreclose the pledge in that context does preserve the borrower's equity of redemption, on the ground that the UCC provides its own right of redemption (i.e., the borrower has the right to redeem its pledged equity interest in the property at any time until the last moment of the UCC auction process).

This line of thinking was dealt a blow in a decision this year by the same court in a related case, HH Mark Twain LP v. Acres Capital Servicing LLC,[2] which clarified that the court's earlier statement had not been a ruling on the borrower's clogging claim, but merely an observation that the redemption right does exist in the UCC foreclosure context. As such, the fact this right exists does not by itself necessarily immunize the lender from the consequences of violating the borrower's separate redemption right in the mortgage foreclosure context. It bears emphasis that the consequence of a final determination against dual-collateral loans on the clogging issue could be the total invalidation of those loans.

It's also worth noting that within the overall debate about dual-collateral loans and clogging there is a further uncertainty about whether merely entering into those loans itself is problematic. There is a school of thought to that effect, and another view that only the actual attempt to enforce the pledge violates the borrower's equity of redemption, such that a lender could safely foreclose the mortgage as long as it leaves the UCC foreclosure route as the road not taken.

CONCLUSION

In times like this, the practical lawyer (of any kind) is spending more time and energy keeping up with developments than ever. Eventually, we will all be back at work in the more normal course of business (whatever that was). It's good to use this time to one's advantage by taking stock of all the changes and thinking clearly about what they mean for law practice. And we're all taking steps in that direction.

Notes

1 HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC, No. 652871/2018, 2018 N.Y. Misc. LEXIS 2472 (N.Y. Sup. Ct. June 19, 2018) (order denying preliminary injunction).

2 HH Mark Twain LP v. Acres Capital Servicing LLC, Index No. 656280/2019, 2020 N.Y. Misc. LEXIS 2515 (N.Y. Sup. Ct. June 2, 2020).

TWENTY THINGS REAL ESTATE ATTORNEYS CAN DO TO NOT MESS UP A SECTION 1031 EXCHANGE

BRADLEY T. BORDEN is a Professor of Law at Brooklyn Law School. He teaches federal income taxation, partnership taxation, taxation of real estate transactions, and LLCs and partnerships. Before entering the legal academy, he practiced law at Oppenheimer, Blend, Harrison & Tate, Inc., in San Antonio, Texas, and continues to practice and advise property owners doing complicated real estate transactions. As the principal of Bradley T. Borden PLLC, he also frequently works as an expert witness or consultant in cases and transactions related to section 1031, partnership and real estate taxation, and other aspects of partnerships and LLCs.

Brad is the author of several books and numerous articles in leading tax and legal journals. His books include Federal Income Taxation, (Foundation Press, 7th ed. 2017, with Martin J. McMahon, Jr., Daniel L. Simmons, and Dennis J. Ventry, Jr.); Federal Taxation of Corporations and Corporate Transactions (Aspen Publishers 2018, with Steven A. Dean); Limited Liability Entities: A State-by-State Guide to LLCs, LPs and LLPs (Wolters Kluwer Law & Business 2012, seven annual updates, with Robert J. Rhee); LLCs and Partnerships: Law, Finance, and Tax Planning (Wolters Kluwer 2019); Taxation and Business Planning for Partnerships and LLCs (Aspen Publishers 2017); Taxation and Business Planning for Real Estate Transactions (Carolina Academic Press, 2nd ed. 2017); and Tax-Free Like-Kind Exchanges (Civic Research Institute, 2nd ed. 2015). His articles are published in professional journals, such as Business Entities, The Journal of Taxation, Probate and Property, Real Estate Finance Journal, Real Estate Taxation, Tax Management Real Estate Journal, and Tax Notes, as well as in law reviews, such as Brooklyn Law Review, Florida Law Review, Florida Tax Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Kansas Law Review, University of Pennsylvania Journal of Business Law, The Tax Lawyer, and Virginia Tax Review. He is also columnist for Journal of Passthrough Entities. He has given more than 250 presentations on topics related to his scholarship.

Brad is a fellow of the American Bar Foundation and the American College of Tax Counsel. He is an active member of the Section of Taxation of the American Bar Association and a past chair of the Sales, Exchanges & Basis Committee of that Section and is active in the Tax Section and Business Law Section of the New York State Bar Association. He earned a B.B.A. and M.B.A. from Idaho State University and a J.D. and LL.M. in taxation from University of Florida Fredric G. Levin College of Law. He is licensed to practice law in New York and Texas, and he is a certified public accountant.

This article was initially conceived for The Practical Real Estate Lawyer's sibling publication, The Practical Tax Lawyer. Part 1 of the version that appeared earlier in The Practical Tax Lawyer covered items 1 through 10 of this list and focused on the issues that arise as property owners begin contemplating an exchange, matters to consider when selecting a QI, and events to plan for as an exchange gets started and the end of the 45-day identification period approaches.[1] This version of the article considers complex transactions and matters that real estate attorneys should keep in mind as they work with their clients to ensure that exchanges progress smoothly and wrap up according to the exchangers' desired tax goals.

Since the manuscript for the version that appeared as Part 1 in The Practical Tax Lawyer was submitted, much has happened in the section 1031 space. Adjustments related to COVID-19 have stalled many section 1031 exchanges. The IRS provided guidance that extends 45-day identification periods and 180-day exchange periods that would otherwise have expired between April 1 and July 15. That guidance brought relief to some exchangers, but the industry generally hoped that the IRS would have done more.[2] As of the writing of this article, the IRS has yet to issue additional guidance, but it indicated that it would.[3] That guidance, if sufficiently generous, will help exchangers better navigate the economic fallout of COVID-19. Many exchanges that stalled will eventually move forward (sooner with the help of generous IRS guidance), and, as the exchange industry returns to capacity, the items discussed in this article will be important to remember.

1. Notify your client if property being sold could qualify for section 1031 treatment

Section 1031 applies to real property held for use in a trade or business or for investment. If the real estate deal that you are working on involves business-use or investment real property, the property may qualify for section 1031 treatment, so let your client know about section 1031. It is not uncommon for a seller to show up at closing, learn that the buyer is acquiring the property to complete a section 1031 exchange, and realize that section 1031 might help the seller defer gain. Although the seller may be able to alter course that late in the transaction and still structure the sale as part of a section 1031 exchange, that last-minute rush makes it difficult for parties to review exchange documents and make sure everything is in order for the closing.

Real estate attorneys should let their clients know about section 1031 well before they get to the closing table. Property held primarily for sale and property held exclusively for personal use does not qualify for section 1031 treatment. Real estate attorneys should let their clients know that any other type of real property might qualify for a section 1031 exchange. To be safe, real estate attorneys should suggest that their clients consult tax experts to assess the viability of doing a section 1031 exchange of any property if there is a chance that their clients will reinvest the proceeds in other real property. It would be a shame for a property owner to sell property, pay tax, and reinvest the remaining exchange proceeds in property that would have satisfied section 1031. Such lost opportunities can be costly, and clients should have a say in the decision to do or not do a section 1031 exchange.

2. Remember that reverse exchanges may be an option

If your client is buying property and may be selling property soon, let your client know that a reverse exchange may be worth considering. Reverse exchanges generally are structured as title-parking exchanges. With such transactions, an accommodator takes title to one of the exchange properties—typically the replacement property, but can be the relinquished property—and holds that title until the exchanger sells the relinquished property. The exchanger uses proceeds from the sale of the relinquished property to acquire the replacement property from the accommodator. The IRS has created a safe harbor for reverse exchanges that can be completed within 180 days. That safe harbor provides significant latitude in structuring the management, financing, and use of the parked property allowing the exchanger to take control of the parked property without becoming the tax owner of it. In Estate of Bartell v. Commissioner, the U.S. Tax Court granted section 1031 nonrecognition to an exchange of property that was parked with the accommodator for more than a year, so these transactions can be structured outside the confines of a safe harbor. Reverse exchanges are form-driven, so adhere closely to the safe harbor or case law.

3. Leasehold improvements are great for the right circumstances

Exchange proceeds can also be used to construct improvements on property the exchanger does not own but will acquire. If an exchanger wants to use exchange proceeds to acquire property and construct improvements on it, the exchanger may consider setting up a title-parking arrangement and have an accommodator acquire the target property and construct the improvements. If the exchanger can complete the improvements within 180 days after the accommodator takes title to the property, then the transaction can be completed within the title-parking safe harbor. Otherwise, the Tax Court's decision in Bartell will provides guidance for structuring the transaction.

If an exchanger wants to use exchange proceeds to construct improvements on property owned by a party related to the exchanger, consider recommending a leasehold improvements exchange. With such exchanges, the related party enters into a long-term ground lease with the accommodator. While the accommodator holds the leasehold, the exchanger directs construction of the improvements. The exchanger then uses the exchange proceeds to acquire the leasehold interest from the accommodator. If the leasehold has at least 30 years to run, then it and the improvements should be valid replacement property. The related-party rules should not be a problem with this type of transaction because the ground lease calls for fair market rent of the land, which the accommodator and then the exchanger will pay. The related party will recognize ordinary income on the receipt of those rental payments. The value of the leasehold to the exchanger will be in the improvements. These types of transactions allow exchangers to reinvest large amounts of exchange proceeds into the replacement property improvements. Because exchangers control the parked property on which the improvements will be built and can control the readiness of the property, they can control the amount that is invested in the 180-day parking period. Thus, the property can be under construction or shovel-ready when the accommodator enters into the lease with the related party, and construction can commence apace, consuming large quantities of exchange proceeds in a relatively short period of time.

4. Understand the (g)(6) restrictions and explain them to your client

QIs exist to ensure that exchangers are not in actual or constructive receipt of exchange proceeds. To provide that benefit, a QI's exchange documents must include the (g)(6) restrictions. The (g)(6) restrictions provide that the exchanger shall not "receive, pledge, borrow, or otherwise obtain the benefit of" the exchange proceeds before the end of the 45-day identification period or exchange period, as appropriate. If the exchanger does not identify any property during the identification period, then the (g)(6) restrictions lapse at the end of the identification period. If the exchanger does not identify any replacement property, the exchanger can receive the exchange proceeds after the 45th day and the sale will be taxable.

If the exchanger has property identified at the end of the identification period, then the (g)(6) restrictions lapse at the end of the exchange period. The exchange period ends at the earlier of: (i) the time the exchanger acquires all identified replacement property; (ii) 180 days after the transfer of the relinquished property; or (iii) the tax return due date (including extensions) for the taxable year during which the sale of the relinquished property occurred if earlier than the date the replacement property is acquired the end of the 180-day period. The period during which the (g)(6) restrictions apply is the "(g)(6) period." During the (g)(6) period, the QI may distribute the exchange proceeds for only a very few reasons. During the (g)(6) period, the QI can distribute the proceeds to acquire valid replacement property and pay transaction costs. Otherwise, the QI must decline any requests to distribute the exchange proceeds during the (g)(6) period.

Real estate attorneys should help their clients avoid working with QIs that disregard the (g)(6) restrictions. The QI safe harbor only works if the exchange agreement includes the (g)(6) restrictions. If a purported QI is willing to make distributions that violate the (g)(6) restrictions as provided for in the exchange agreement, the distributions will negate the safe harbor as it applies to the exchanger. If the safe harbor is negated, the exchanger will most likely be deemed to be in constructive receipt of the proceeds held by the purported QI. The exchanger would therefore owe tax on all the gain realized on the sale of the relinquished property. What's worse, is the IRS could consider the (g)(6) language in all of the purported QI's documents to be illusory. If so, all of the agreements the purported QI has entered into would be deemed not to have the (g)(6) restrictions and the intermediary would not satisfy the QI safe harbor. In such a situation, all of the exchangers who have worked with that intermediary would likely be deemed to be in constructive receipt of the proceeds held by the purported QI. Real estate attorneys should be aware of this possibility and steer their clients away from QIs that do not enforce the (g)(6) restrictions. They should also help their clients understand that the benefit of using a QI comes with the cost of tying their exchange proceeds up throughout the duration of the (g)(6) period. Clients who understand this trade off typically concede that the QI should not distribute the proceeds before the end of the (g)(6) period.

5. Know the QI industry

Qualified intermediaries facilitate almost every section 1031 exchange. The QI industry has several hundred QIs, but not all QIs are equal, and the QI industry is unregulated. Consider three general types of QIs. A handful of national QIs are affiliated with title companies or banks. Such QIs typically have a corporate office with highly talented exchange specialists and people in regional offices with expert knowledge of section 1031 and the exchange process. Some QIs are privately owned stand-alone operations, but they can also be very sophisticated. Some real estate attorneys and exchangers have developed relationships with practicing attorneys who have side QI businesses. These three types of QIs (bank- or title company-affiliated, stand-alone, attorney side business) represent the vast majority of QIs.

The QI industry is not regulated, but, for the most part, QIs behave well and carefully manage the significant amount of cash they hold for exchangers. There are, of course, exceptions to the general practice. For instance, the financial crisis of 2008 exposed some QIs that had either stolen or mismanaged exchange proceeds. In one instance, Ed Okun purchased many privately-owned Stand-alone regional QIs and used the exchange funds as his personal piggy bank. In another instance, LandAmerica Exchange Services Inc. invested exchange proceeds in auction-rate securities that became illiquid during the financial crisis. At that time, QIs' "float" got quite a bit of attention. Float is the amount of exchange proceeds that a QI holds on average. For instance, a QI that does several hundred exchanges a year could have a float of $150,000,000. If the owner is comfortable that the float will never go below $100,000,000, the owner might become more aggressive in investing that amount in something like auction-rate securities that provide a return that beats typical deposits. Or, in Ed Okun's case, the owner might decide to "borrow" from the float to temporarily improve his lifestyle. Such strategies work if the float maintains its typical level. For the float to remain at its target level, however, deal-flow must remain constant to ensure that sufficient funds are flowing in to meet the demand to distribute funds. Unfortunately, the real estate market dipped during the financial crisis, slowing deal-flow, and causing the QIs' float to dip below its customary levels. LandAmerica Exchange Services got caught because the financial crisis froze auction-rate securities, causing them to become illiquid, and it could not convert those securities to cash fast enough to meet the demands to distribute exchange proceeds. Ed Okun had spent the money he took from the QIs he controlled, so he was in no position to return those proceeds and fund the demands for exchange proceeds.

When a QI fails, exchange proceeds get tied up in bankruptcy proceedings, at least temporarily. If funds are unavailable, exchangers cannot complete their exchanges. If exchangers needed the funds to close on replacement property they had under contract, they could be liable for breach of contract if they could not otherwise deliver proceeds to acquire that property. Of course, the loss of funds also creates financial hardship for exchangers when a QI collapses. It may surprise some observers to learn that over time the bankruptcy trustees of the failed QIs were able to return amounts to exchangers that were often within a few percentage points of the total amounts they had deposited with the QIs. Some of the funds came from the QI or assets under investment as they became liquid, but banks and other third parties who were close to the failed QIs also ended up paying into the bankruptcy estate in settlement of claims against them. Of course, recovery of the funds took months or years, so the exchangers lost the benefit of tax deferral on the sale of their property, and they could have recognized gain as the payments were received.

Inevitably, real estate attorneys get drawn into malpractice claims when some of their clients lose money in QI failure. Some such claims are without merit. For instance, claims that the attorney should have known about the financial health of a company like LandAmerica Exchange Services is unreasonable. Even though it was part of a publicly traded company, relevant facts about its financial stability and use of exchange proceeds were not published until the bankruptcy was announced. From an outsider's perspective, LandAmerica Exchange Services appeared to be a financially sound QI until it was too late for exchangers to do anything to protect themselves. Rumblings about Ed Okun were nothing more than rumblings until the very end. People who had suspicions about his activities did not have sufficient proof to expose his nefarious work until it was too late.

A few exchangers who had hired LandAmerica Exchange Services as QI had placed exchange proceeds in qualified escrow accounts, and they were able to obtain their proceeds much earlier than exchangers who simply had proceeds on deposit with LandAmerica Exchange Services. The distributions were probably too late to afford the exchangers the opportunity to complete exchanges, so they lost the tax benefit of section 1031. Some exchangers who saw that happen claimed that their real estate attorneys should have told them about the availability of qualified escrow accounts and qualified trusts. Those claims should put all real estate attorneys on notice, and they should consider advising their clients of the possibility of using a qualified escrow account or qualified trust in addition to hiring a trusted QI. Qualified intermediaries often have documents and systems in place to incorporate qualified escrow accounts and qualified trusts into exchanges, but they generally only implement such tools upon request from the exchanger. Real estate attorneys can apprise clients of those tools and request that the QI provide information about them.

6. Avoid accommodating accommodators

Because the QI industry is not regulated, real estate attorneys should ensure that their clients avoid purported QIs who cut corners and flout the rules. In addition to minimizing the importance of formal QI requirements and absconding with funds, QIs can do other things that jeopardize exchanges they are hired to help facilitate. As stated above, exchange agreements must include the (g)(6) restrictions, and exchangers must adhere to particular rules in identifying replacement properties within the 45-day identification period. Qualified intermediaries should help ensure that exchanges they facilitate comply with these rules. Some QIs get the reputation of being "accommodating accommodators" because they are willing to distribute proceeds prior to the end of the (g)(6) period. As discussed above, serious doubts exist as to whether such accommodators come within the definition of QI if they do not comply with the (g)(6) restrictions. Real estate attorneys should help their clients steer clear of such accommodators.

Some accommodators also are known to be willing to fudge on the identification rules. A talked-about trick such accommodators use is accepting a signed identification form within the 45-day identification period with reference to an attachment that lists the identified property. The trick being that the exchanger will later send the attachment, presumably after the end of the identification period, with the identified property. Not only would that be an invalid identification, it sounds like an effort to deceive the IRS, which could be fraud. Another talked-about trick is that exchangers will submit two sealed envelopes, each with identified properties and, after the 45-day identification period, let the QI know which letter to open and which one to dispose of. This, too, would violate the identification rules and would be a fraudulent identification. Real estate attorneys should avoid assisting with such shenanigans and should help their clients steer clear of accommodators who would entertain such tricks. The real estate bar should expect QIs to abide by the highest standards of professionalism and ethics and should refuse to work with QIs who do not abide by such standards.

7. Know the identification rules

Section 1031 allows exchangers to identify up to three properties without regard to the value of the properties (the three-property rule) or any number of properties if the total value of the identified properties does not exceed 200 percent of the value of the relinquished property (the 200 percent rule). Exchangers can identify properties at any time during the 45-day identification period and can revoke an identification at any time during that period and identify another property or let the period lapse with no identified property. As reiterated below, recognize that if you are assisting with a property that ceases to be a viable replacement property before the end of the identification period, let your client know that there is still time to identify something else or end the exchange and receive the proceeds after the end of the identification period.

8. Know the identification deadline

An exchanger must identify replacement property within 45 days after the transfer of the relinquished property. Real estate attorneys should know when the 45-day identification period ends for each transaction that they work on, especially if they are assisting with the acquisition of replacement property. Except in uncommon situations, such as the exchanger being affected by a federally declared disaster or serving in the U.S. armed forces in a combat zone, the 45-day period is not negotiable. Identifications can be revoked, so typically it is better to identify favorite properties a few days before the end of the identification period and change the identification at the last minute if needed than to miss the deadline altogether and fail to identify property. Be sure to revoke any prior identifications as needed to ensure that the total number or value of identified properties comes within the relevant prescribed limit.

COVID-19 has disrupted normal practices, affecting many exchangers' ability to complete section 1031 exchanges. The IRS issued Notice 2020-23 on April 9 extending the deadline for time-sensitive actions (including section 1031 identification and replacement-property acquisition) otherwise required to be completed between April 1 and July 15. Typically, such relief extends deadlines for 120 days or to the date in the IRS notice, whichever is later (whichever-is-later rule). Some observers are concerned that Notice 2020-23 might not apply the whichever-is-later rule and limit the extension to July 15. Nonetheless, a strong argument favors applying the whichever-is-later rule, which would extend affected section 1031 periods 120 days. Because commentators disagree about the length of the extensions, exchangers and their advisors must carefully study existing and future guidance when making decisions affected by the extension guidance.

Once the IRS issues guidance extending the section 1031 periods, the extensions appear to be elective, and they apply to the identification and exchange periods. The (g)(6) restrictions should also apply to those extended periods. Consequently, if an exchanger chooses to apply the extensions, the exchanger should plan for the exchange proceeds to be subject to the (g)(6) restrictions for the extended periods. Many exchangers will accept the prolonged restrictions to take advantage of the extra time and capitalize on any opportunities in real estate markets that might arise during the extended period, but they need to understand the risks of drawing money from a QI and leaving it on deposit.

Concerned for exchangers that were unable to complete exchanges due to COVID-19 and measures taken to protect against it, industry groups have requested that the IRS make the disaster date earlier than April 1, perhaps as early as January 20. Those groups argue that the extensions should apply to any exchange that begins between the earlier disaster date and July 15. The IRS has indicated that it will issue FAQs to address some of the uncertainty related COVID-19 and the extension dates, but the IRS had yet to issue that additional guidance as of the date this article went to press.

If you are assisting with the acquisition of a potential replacement property and realize before the end of the identification period that the exchanger will not acquire it, let the exchanger know. The exchanger can then remove it from the list of identified property and add a different replacement property to the identification form. If the property you are working on is the exchanger's only choice for replacement property and its acquisition becomes unrealistic, let the exchanger know to revoke the identification and receive the exchange proceeds after the end of the identification period. Remember that if the exchanger has property identified at the end of the

45-day identification period, the exchange proceeds will be tied up until the end of the exchange period. The exchanger should not be in that situation, if the exchanger has decided not to acquire any replacement properties. Do not let the identification period lapse with properties identified that the exchanger has no interest in acquiring or will otherwise be unable to acquire.

9. Use caution when deferring gain by straddling taxable years

Real estate attorneys should know that if an exchange straddles taxable years, gain typically is recognized in the year the funds become available. For instance, if an exchanger sells property in December 2020 and has a bona fide intent to do an exchange, as evidenced by hiring a QI to facilitate the exchange, the exchanger would not be able to access the exchange proceeds until sometime in 2021. If the exchanger does not identify replacement property and receives the exchange proceeds at the end of the 45-day identification period, the exchanger would recognize gain in 2021 when it receives the exchange proceeds under the installment method. This rule allows exchangers to defer paying tax for a year by deferring receipt of sale proceeds for 45 days. Some property owners might believe that they should take advantage of this one-year deferral by setting any sale up as a potential exchange. They can set a sale up as a potential exchange that defers gain for one year by timing it to come within the last month or so of the year (or last six months, if they are will to defer payment until the end of the exchange period) and hiring a QI to hold the proceeds.

Be aware, however, that if the exchanger uses the unadjusted basis of the property to allow for the 20 percent passthrough deduction under section 199A, it will lose the benefit of the unadjusted basis if it does not hold property at the end of the year. The lost deduction might not offset the benefit of deferring gain for a year. Exchangers can either choose not do an exchange or elect out of the installment method to ensure that gain is recognized in the year of the disposition, not the year the payment is received. If they wish to take advantage to the exchange property's unadjusted basis for purposes of the section 199A deduction, they should arrange to hold the relinquished property until after the end of the year or to acquire the replacement property before the end of the year.

10. Consider whether proceeds from blown exchanges may be investable in qualified opportunity funds

Consider whether the exchanger could try to invest any unused exchange proceeds in a qualified opportunity fund (QOF). Typically, a person can qualify for deferral by investing gain in a QOF within 180 days after property is sold. The QOF 180-day period can have multiple start dates for a single gain. For instance, if an individual sells property, the 180-day period generally begins on the date of the sale. If gain is recognized under the installment method, the QOF 180-day period begins, at the election of the taxpayer, when payments are received or at the end of the taxable year that the payments are received. To illustrate, if a person sold a property on July 15, 2020, for a note that qualifies for the installment method, the person would recognize gain when the note payments are received. Assume the person receives payments on March 1, 2021, and August 1, 2021. The QOF rules allow the person to start the QOF 180-day periods on March 1, 2021, and August 1, 2021, or to start a single QOF 180-day period for both 2021 payments on December 31, 2021. The person could also elect out of the installment method and start the QOF 180-day period on July 15, 2020.

Knowing the QOF 180-day period can be important for exchangers. If an exchange straddles two years and does not elect out of the installment method, the installment method defers the gain until the year of receipt. The QOF rules therefore appear to allow the 180-day period to begin on the date that the QI distributes exchange proceeds or December 31 of the year of distribution. If an exchanger sold property on July 15, 2020, and received any unused exchange proceeds on January 11, 2021, the last day of the exchange period, the first QOF 180-day period would begin on January 11, 2021, but the exchanger could elect for it to begin on December 31, 2021. The exchanger could also elect out of the installment method and have the QOF 180-day period begin on July 15, 2020. Because the exchange period and QOF reinvestment period are both 180 days, exchangers would not appear to gain an advantage by electing out of the installment method. If an exchange straddles two taxable years, the exchanger has multiple QOF 180-day periods starting on the following dates:

- The date the property was sold. The exchanger must elect out of the installment method to use this period. This period will run concurrently with the exchange period and often prevent the exchanger from investing in an opportunity fund during that period;
- The date the QI distributes exchange proceeds; and
- The last day of the taxable year during which the QI distributes exchange proceeds.

If a partnership transfers property, the general QOF 180-day periods apply to the partnership. If a partnership does not reinvest sale proceeds in a QOF, partners can reinvest their share of the partnership gain in a QOF. Partners can choose from several 180-day periods beginning on any one of the following start dates: (i) the date the partnership sells the property; (ii) the end of the partnership's taxable year; or (iii) the partnership's tax return due date. If a partnership is doing an exchange and does not elect out of the installment method, the partnership can use the QOF 180-day period beginning at the time the QI distributes the proceeds or it can use the December 31 (assuming that is the last day of the partnership's taxable year) of the year of the distribution. If the partnership does not reinvest the proceeds distributed from a QI, the partners can also use the 180-day periods that apply to the partnership, or they can use the 180-day periods beginning on the last day of the partnership's taxable year during which it receives the payments or its return due date for that same taxable year (usually March 15 of the year following the taxable year). Thus, assuming the partnership does not reinvest the exchange proceeds in a qualified opportunity fund, a partner could choose from any of seven different QOF 180-day periods to reinvest the exchange proceeds in a qualified opportunity fund starting on the dates described below.

Dates concurrent with the partnership:

- The date the property was sold. The partnership must elect out of the installment method and not reinvest the proceeds in a QOF for a partner to use in this period. This period will run concurrently with the exchange period and often prevent the exchanger from investing in an opportunity fund during that period;
- The date the QI distributes exchange proceeds; and
- The last day of the taxable year during which the QI distributes exchange proceeds.

Dates associated with the partnership year-end and return due date:

- Partnership elects out of installment method—(i) December 31 of year of sale; or (ii) partnership tax return due date for year of sale.
- Partnership does not elect out of installment method—(i) December 31 of year of receipt of proceeds; or (ii) partnership tax return due date for year of receipt of proceeds.

11. Don't drop the ball on a drop-and-swap

Drop-and-swaps have become commonplace, and many real estate attorneys see several of these types of transactions each year. A drop-and-swap is a series of transactions that often starts when a tax partnership (i.e., a partnership or LLC taxed as a partnership) receives an offer to purchase its property and the members disagree about how to reinvest the proceeds. Some members of the tax partnership might prefer to reinvest the proceeds in like-kind property as part of a section 1031 exchange; others might wish to do their own exchange, and others might wish to take cash and forgo other investments in real estate. To accommodate all parties, the tax partnership can consider liquidating by distributing tenancy-in-common (TIC) interests to each of the members. The members could then do as they please with their respective TIC interests.

Even though drop-and-swaps are easy to explain, they are complex transactions and have a few potential tax traps. When advising a client with respect to a drop-and-swap, remember that the property must be held as a TIC for tax purposes following the distribution. The advisor must understand the difference between a TIC and a partnership under tax law. For the members of a tax partnership to be treated as TIC co-owners, the partnership must distribute tax ownership of the TIC interests to the members, i.e., the members must acquire the benefits and burdens of the TIC interests.

If the partnership negotiates, the sale enters into the purchase agreement, and takes all of the actions necessary to sell the property, the IRS and courts could treat the partnership as holding the benefits and burdens and as owning the property at the time of the sale. If the partnership owns and sells the property, then it must complete the section 1031 exchange by acquiring the replacement property. Ensuring that tax ownership passes from a tax partnership to the member or members and that the post-distribution arrangement is a TIC, requires prior proper planning. Thus, it is best to get the wheels of a drop-and-swap turning well before the sale occurs.

12. Know what a TIC is and isn't

Having heard about drop-and-swaps, some real estate lawyers may believe that they can accomplish a good drop-and-swap by simply deeding the property from the partnership to the members as TICs right before closing. Unfortunately, tax law might not treat the ownership arrangement of a last-minute distribution followed immediately by a sale as a TIC. Experts in partnership classification believe that for an arrangement to be a valid TIC, it must have a few fundamental TIC characteristics. First, the members must generally have rights to partition the property and sell their TIC interests. Second, any blanket liens on the property should be borne by the members in proportion to their ownership interests. Third, revenue and expenses should be shared by the owners in proportion to their ownership interests. Fourth, the members should share in the management and decision-making related to the property. To comply with these requirements, co-owners of TIC arrangements typically adopt a TIC agreement and a management agreement.

Distributing TIC interests immediately prior to the sale of property raises questions about the status of the interest owned and transferred. If the property is held by the members for only an instant, the members may have difficulty establishing that the transitory arrangement was a TIC. For instance, they might not be able to show that they shared revenue and expenses according to their ownership interests, that they had rights to partition, that they had management rights, that they shared the blanket liens in proportion to their ownership interests, and that they satisfy the other criteria of a TIC for the brief instant between the distribution and the transfer. A properly structured drop-and-swap ensures that the property is distributed and held as a TIC before it is transferred to the buyer.

On the buyer side, exchangers often look to purchase TIC interests as replacement property. They may intend to hold those interests passively, or they may wish to participate in the management of the acquired property. For instance, a developer may wish to be part of a venture to acquire and develop land. The developer may prefer to acquire its interest in the property as part of section 1031 exchange. The developer cannot acquire a joint venture interest (i.e., an interest in a partnership or LLC) as part of an exchange, but it could acquire a TIC interest in the property to be developed. After establishing tax ownership of a TIC interest, the developer might consider contributing the property to a joint venture. From a tax planning standpoint, the developer is probably better off exchanging into a single TIC that will be folded into a joint venture (i.e., a quick TIC) than exchanging into a complex TIC that will develop property. A TIC that develops property often will be so complex that it could start to look like a tax partnership. Based upon Magneson v. Commissioner and its progeny,[4] the quick TIC can have

TIC tax attributes and then fold into the joint venture without negating the section 1031 exchange. With quick TICs, be certain the exchanger is the tax owner of the TIC interest and ensure that the stop transaction doctrine does not disregard that step.

Closely held TICs have become very prevalent. Sponsors of real estate funds and joint ventures want to use equity and management structures for such TICs that they use in their joint ventures, complete with profit-sharing and promotes. Some TIC arrangements have TIC agreements and management agreements that appear to comply with Rev. Proc. 2002-22 also include side letters that may introduce profit-sharing or management features that deviate from the guidelines in Rev. Proc. 2002-22. If the arrangements in the side letters would disrupt the TIC classification if they were in the TIC agreement or management agreement, they will likely disrupt the classification from outside those agreements. Because distinguishing between a tax partnership and a TIC is so difficult in many situations, one would not expect to see tax authorities aggressively challenge arrangements that do not perfectly comply with the Rev. Proc. 2002-22 conditions. Nonetheless, egregious deviations may attract the attention of taxing authorities, so don't deviate too far from the guidelines. Profit sharing that is not in proportion to ownership interests may be a deviation that strays too far from the guidelines, and it is easy for tax authorities to recognize and challenge. Some observers believe that arrangements within the entity structures of TIC owners might be a better way to deal with profit sharing and promotes. For instance, a manager may become a member of an LLC investor that is buying a TIC interest and get a profits interest for managing that entity or providing management services to it, instead of receiving a profits interest through the TIC management agreement. If the law respects every entity in the structure, then arrangements in the upper-tier entities or TIC should not disrupt the TIC classification. Issues related to side letters and agreements with structures are still being explored and fleshed out. Industry practices should normalize relatively quickly as demand for such structures grows. In the meantime, be careful to ensure that your arrangement does not become an example of how not to structure a TIC.

13. Know that an S corporation is not a tax partnership

Partnerships and S corporations are both pass-through entities, so they do not pay an entity-level tax. Instead, the income of both types of entities flows through to the members who pay tax on their respective shares of it. Despite that similarity, partnerships and S corporations are different in significant ways that are relevant in the section 1031 context. For instance, S corporations typically recognize gain when they distribute appreciated property to their members, and they must allocate recognized gain pro rata to the shareholders based upon the shareholders' ownership interests in the S corporation. Therefore, S corporations cannot do drop-and-swaps in the same way that partnerships can. If an S corporation simply distributes appreciated property to the shareholders, the corporation recognizes gain, allocates the gain to the members in proportion to their interests in the S corporation, and the members take a fair market value basis in the distributed property. After that gain recognition, the members would have no reason to do exchanges. If only one member wanted to cash out, the S corporation would recognize gain if it were to distribute an undivided interest to the cash-out member or receive cash boot on the sale of property as part of a section 1031 exchange, and it would have to allocate that gain pro rata to the members.

Shareholders do not, however, have to abandon all hope of dividing S corporations tax-free in proximity to doing an exchange. S corporations are subject to the general corporate tax rules, which allow for tax-free divisions. To obtain tax-free treatment on a division of a corporation, the division must have a non-tax business purpose, the pre-division corporation must have an active trade or business, the shareholders must retain their proprietary interests in at least one of the corporations that results from the division, and the business of the divided corporation must continue after the division.[5] These rules limit the types of S corporations that are eligible for tax-free divisions and may restrict the timing of such divisions. An S corporation may have difficulty satisfying the business purpose requirement if it distributes TIC interests to the members as part of the division. Often, the most obvious business purpose for doing a division is a management dispute and disagreement regarding the use and disposition of the corporation's property. If an S corporation has multiple members and multiple properties and divides the management of the properties among the members, a purpose for dividing may be to grant specific members greater management latitude with respect to specific properties. A fundamental attribute of a TIC is that the TIC owners participate in the management of the TIC property, so a division resulting in multiple corporations owning TIC interests probably would have to have a business purpose other than management differences.

An S corporation with multiple properties probably could do a tax-free division by distributing a property out to one of the shareholders. Following such a division, the new corporation and the dividing corporation would both hold at least one property. Each corporation should then be able to do a section 1031 exchange without disrupting the tax-free division. The division could, however, lose its tax-free status if either resulting corporation started but failed to complete an exchange. An S corporation should also be able to exchange out of one property into multiple other properties and then do a tax-free division. After a corporate division, the resulting entities will be corporations. Continued corporate ownership is not the ideal structure of real property (the owners would probably prefer to own the properties in tax partnerships), but a tax-free division does allow the owners to go their separate ways. Tax-free divisions of corporations have several technical requirements, so do them with care to ensure all the technical requirements are satisfied.

14. Recognize you're not a DST, NNN, or TIC broker

A significant marketplace exists for packaged replacement property, such as DSTs (interests in Delaware statutory trusts), NNNs (triple-net properties), and syndicated TICs. Each of these products provides passive investments for parties looking for real estate interests and minimal management responsibilities. For instance, triple-net properties are typically standalone properties with credit tenants. Exchangers often transfer out of property they have owned and managed and with which they are familiar into triple-net properties with which they have little or no familiarity. Some exchangers will visit such properties before acquiring them; others buy them sight unseen relying solely on financial information provided by the seller and the tenant's credit worthiness.

DSTs have become a popular form of replacement property. They allow investors to buy a fractional interest in a larger property or properties. A DST is a legal entity that tax law disregards if the DST satisfies certain requirements that create a fixed investment for members of the DST. The fixed investment requirement prohibits the DST from refinancing, making significant structural improvements to, or negotiating new leases for its property. Those restrictions should generally limit DSTs to owning new construction or recently renovated property. When property owned by a DST reaches a point that requires renovation, the DST must sell it.

Syndicated TICs were popular in the 2000s prior to the financial crisis, but they have lost their luster. An investor could probably find a syndicated TIC to invest in, but sponsors and lenders prefer DSTs because they employ a separate legal entity.

Investors should note how COVID-19 affects these types of arrangements. Rent payments and other revenue from the properties might decrease significantly for some types of properties, such as student housing, office buildings, and hotels. Reportedly, sales of DSTs that were on the market before COVID-19 have slowed. Loss of rent revenue will affect DST distributions. The situation at the time of this writing is worrisome for parties in the DST space. The speed at which the economy returns to normal will affect recovery of this market segment.

Real estate lawyers should be familiar with the legal aspects of TICs, DSTs, and triple-net replacement properties, but they should be careful not to promote any particular property. The industry is effective at getting their product in front of potential investors. Attorneys should be sure that any advice they give with respect to potential replacement property is within the scope of their representation, and they should recognize that not all products or sponsors adhere to the same standards of care and quality. Attorneys should also remember that their ethical duties require them to represent the client and should be certain any product their client is considering complies with section 1031 or other tax rules relevant to the transaction.

15. Use caution if replacement property comes from a related party

The IRS and courts do not like exchangers acquiring replacement property from related parties and generally deny section 1031 nonrecognition to such transactions. Courts have decided several cases with such facts, and the exchangers have lost in every case. The related-party exchange rules provide a defense for exchanges that are not tax motivated. Perhaps an exchanger could argue for the application of this no-tax-avoidance defense if the related party recognizes gain and pays more tax on more gain than the exchanger defers. An exchanger typically would not acquire property from a related party if the acquisition would not yield greater tax savings, so this no-tax-avoidance defense typically will not be available. If the related party recognizes gain but has losses to offset the gain, courts do not appear willing to grant the exchanger nonrecognition of gain on the exchange, even if the related party's recognized gain exceeds the exchanger's deferred gain.

16. Know that serial exchanges are an exception to the general related-party prohibition

One exception to the rule prohibiting the acquisition of replacement property from a related party is a transaction in which the related party uses the proceeds to do its own exchange. With such transactions, the IRS has privately ruled that the exchanger's and related party's exchanges can qualify for section 1031 treatment. The related party can also acquire its replacement property from a second related party if the second related party does a section 1031 exchange. An ownership structure with several properties owned in several different related tax entities such as a large REIT or real estate fund, could string several exchanges together with a series of connected exchanges. The ability to string exchanges together in this manner gives these structures the appellation "serial exchanges" or "daisy-chain exchanges."

The benefit of serial exchanges should be obvious. If the related-party group is considered a single economic unit, then serial exchanges allow the economic unit to extend the 45-day identification period and 180-day exchange period indefinitely. If an exchanger anticipates it will not be ready to complete the exchange within its 180-day exchange period, it can identify a related party's property and acquire it prior to the end of the 180-day period. The related party then has 45 days to identify replacement property and 180 days to acquire it. If the related party is concerned that it won't be able to acquire replacement property within its 180-day exchange period, it can identify another related party's property and keep the chain going by acquiring replacement property from that other related party. The possibility of benefitting from serial exchanges may prompt some property owners to structure ownership of multiple properties with multiple related entities. Creating related parties to own separate properties can also lay the groundwork for doing leasehold improvement exchanges.[6]

17. Selling to a related party is probably fine

The IRS allows exchangers to sell relinquished property to a related party and do an exchange (through a QI) with the proceeds the related party pays for the property. Knowing this can come in handy if the exchanger is considering doing a so-called Bramblett exchange in which it locks in capital gain treatment on property held for investment before selling it to a related-party developer.[7] The investment entity in such a transaction should be able to use the proceeds from the sale to the related-party developer to do a section 1031 exchange (if the developer entity acquires the property with a note, then the transaction will require additional planning). There may be other reasons for selling property to a related party as part of a section 1031 exchange, so be aware that the IRS has sanctioned such transactions.

18. Know when the exchange period ends

The exchange period runs until 180 days after the exchanger transfers the relinquished property. That period can be cut short if the tax return due date for the year of the exchange is before the end of the 180-day period. Know that your client can avoid having the 180-day period cut short by filing an extension. Thus, if an exchange starts towards the end of the taxable year (assuming a calendar taxable year) and the 180-day period will end after March 15, if the exchanger is a partnership or S corporation, or after April 15, if the exchanger is an individual or C corporation, let your client know to file an extension to get the full benefit of the 180-day period, assuming the exchanger needs additional time to complete the exchange. Due to COVID-19, the 2020 filing deadlines between April 1 and July 15 have been extended until July 15.[8] Such extensions are not typical, but when they happen they could be relevant to the exchange period. If the exchanger prefers to receive exchange proceeds and not continue the exchange, advise the exchanger to not extend the return and to not take advantage of any extension relief. When the exchange period ends, the (g)(6) restrictions cease to apply.

The 180-day period can only be extended by the IRS for a limited number of reasons, which require other federal action, such as a federally declared disaster.[9] Absent such an extension, the 180-day period is definitive, and it can end on a holiday or weekend, so be sure to close on property before the end of the exchange period, if necessary.

19. Follow the money: replace value, replace equity

Cash is king in section 1031 exchanges, just like it is with most other things, because an exchanger's actual or constructive receipt of cash will trigger gain recognition. Real estate attorneys should pay close attention to the flow of funds, ensuring that proceeds from the sale of relinquished property get to the QI and get used to acquire replacement property. To totally defer gain, an exchanger must acquire replacement property that is equal to or greater in value than the relinquished property (the equal-value rule), and the equity (value of the property minus the debt encumbering it) in the replacement property must be equal to or greater than the equity in the relinquished property (the equal-equity rule). Thus, if the relinquished property has debt, the exchanger can defer all of the gain on the sale of that property only by replacing the debt or putting additional capital into the acquisition replacement property.

Often, acquisition financing will include funds for capital improvements to the replacement property. In such situations, the sum of the loan proceeds and exchange proceeds coming to closing might exceed the value of the replacement property (perhaps the extra proceeds will be used for capital improvements), but the exchanger must comply with the equal-value rule and the equal-equity rule to avoid gain recognition. Assuming the replacement property satisfies the equal-value rule, the exchanger can satisfy the equal-equity rule only by ensuring that all of the exchange proceeds are used to acquire the replacement property and any extra cash comes from financing. The most conservative way to ensure that the extra cash comes from a loan is to close on the replacement property and then enter into a new loan for the extra proceeds. Often that course of action is not feasible because the lender will only do one set of loan documents and is not interested in delaying the distribution of proceeds. A next-best course of action is to ensure that the closing statement clearly identifies the exchange proceeds being used to acquire the replacement property and that any cash the exchanger receives comes from the loan.

At a courtesy meeting with the IRS as part of the American Bar Association Tax Section meeting in May 2019, attorneys at the IRS Chief Counsel's Office indicated that tracing exchange proceeds from the QI to seller and loan proceeds from the lender to exchanger is acceptable. They suggested that as long as the exchange satisfies both the equal-value rule and the equal-equity rule (the loan proceeds received by the exchanger at closing would not be considered debt for purposes of computing the property's equity), the cash received at closing should not be treated as boot. Although such communication is not an authoritative statement of law, it did give confidence to the practitioners present at the meeting to move forward with such transactions when no other alternatives are feasible.

Real estate attorneys should also be mindful that closing adjustments can have tax consequences. Transaction costs, such as attorneys' fees, transfer taxes, QI fees, brokers fees, and survey and engineering fees, paid at closing reduce the amount realized of sold property or increase the basis (i.e., cost) of acquired property (in the case of purchased property, but use of exchange proceeds to pay those costs should not affect the basis of property acquired in an exchange), so they do not affect the taxability of an exchange. Adjustments for prepaid rent, taxes, security deposits, and other items can have tax consequences. Any exchange proceeds used to pay such items for the seller will be boot to the seller. If the items are deductible, the deduction will offset the boot, but if the parties can ensure that the exchange proceeds go to the QI and the adjustments get paid outside the closing, the seller could take the deduction against other income.

In the case of security deposits transferred to the buyer, if the deposits are paid out of exchange proceeds through a credit to the purchase price, the buyer would most likely have boot and have no offsetting current deduction. In such a situation, the buyer should insist upon having the seller write a separate check to transfer the security deposits. Real estate attorneys should take the closing statement seriously and identify any items that could trigger boot. Some exchangers may prefer to settle those items on a separate closing statement and use proceeds from sources other than the exchange proceeds to pay for those items.

20. Have the best section 1031 people in your contacts folder

Section 1031 has become commonplace and many real estate attorneys have done dozens, hundreds, or even thousands of section 1031 exchanges. Such attorneys are very familiar with the section 1031 exchange process, but many exchanges involve complex tax matters or tax issues outside of section 1031. Get a section 1031 expert on board whose expertise covers section 1031 and other relevant areas of tax law to ensure that all technical requirements are satisfied and other tax issues are considered.

Section 1031 can be a wonderful tax-saving device. Some exchanges seem routine, and you may feel comfortable relying solely on the QI for tax advice regarding your exchange. Use caution in doing so. Qualified intermediaries generally include disclaimers in their documents and marketing materials providing notice that they do not provide tax advice. If they are not your client's attorney their communication may not be protected by the attorney-client privilege, and the QI may not be subject to the rules of ethics that govern attorneys.

Qualified intermediaries will become disqualified if their advice extends beyond advice with respect to exchanges intended to qualify for section 1031 nonrecognition.[10] The QI rules do not establish the parameters of what constitutes advice with respect to an exchange intended to qualify for section 1031 nonrecognition, so one cannot know with certainty if a QI crosses that line. If the advice is limited to the identification rules and the identification and exchange periods, then most observers would agree that the advice is with respect to an exchange intended to qualify for section 1031 non-recognition. If the advice relates to whether a TIC is a partnership or whether a drop-and-swap qualifies for non-recognition on both the distribution and the exchange, then the advice may cross the line and relate to classification of an arrangement and tax treatment of a partnership transaction. If that happens, then the QI safe harbor could cease to apply, and the exchange may not qualify for nonrecognition.

To avoid those problems and ensure that all aspects of a section 1031 are properly considered and applied, recommend that your client hire a section 1031 expert to assist with the exchange. Even when the exchange seems simple, if the dollars justify hiring an expert, don't take chances—get an extra set of expert eyes to review the exchange. It can't hurt to have a set of trained eyes review every aspect of the exchange. If the transaction is complex, definitely suggest that your client enlist expert help to assist with planning and executing the transaction. The cost of such help will be slight compared to the cost of defending problems that arise from oversight or neglect of important issues.

Conclusion

Section 1031 is a great tax-saving mechanism and section 1031 exchanges are ubiquitous. Real estate attorneys are on the front lines of exchanges. They should be mindful of situations that lend themselves to section 1031 treatment and help their clients understand the benefits of section 1031 deferral. Real estate attorneys should also be aware of issues that come up in section 1031 exchanges and be prepared to handle those issues or bring in tax specialists to help with those matters. Interesting and perplexing issues can arise even in what appear to be straightforward, simple exchanges. By being mindful of the 20 issues discussed in this article, real estate attorneys can help reduce the risk of overlooking a relevant issue or matter and help ensure that an intended exchange obtains the tax goals the exchanger is pursuing.

Notes

1 See Bradley T. Borden, "20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10)," in the May issue of The Practical Tax Lawyer.

2 For an in-depth discussion of extensions of the section 1031 periods, see Bradley T. Borden, "Universal Deadline Extensions Draw Attention to Section 1031 Periods," 167 Tax Notes Fed. 603 (Apr. 27, 2020). See also American Bar Association Section of Taxation, "ABA Tax Section Follows Up on Preliminary COVID-19 Remarks," 2020 TNTF 85-21 (Apr. 29, 2020); Letter from Real Estate Coalition Requesting Clarification of Disaster Relief for § 1031 Exchanges (Apr. 20, 2020), available at https://v6k8u5d3.stackpathcdn.com/wp-content/uploads/2020/04/LKE-Coalition-letter-to-Treasury-IRS-re-Notice-2020-23-4.20.20.pdf?x44329..

3 See Kristen A. Parillo, "FAQ Coming on Like-Kind Exchange Extensions," Tax Notes Federal, Apr. 20, 2020, p. 527.

4 For an in-depth discussion of those cases, see Bradley T. Borden, "Section 1031 Drop-and-Swaps Thirty Years after Magneson," 19 J. Passthrough Ent. 11 (Jan.-Feb. 2016).

5 See I.R.C. § 355; Treas. Reg. § 1.355-1, -2.

6 See Bradley T. Borden, 20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10), supra; "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 J. Tax'n 22 (Jan. 2003) (with Alan S. Lederman and Glenn Spear).

7 See "Accounting for Pre-Transfer Development in Bramblett Transactions," 41 Real Est. Tax'n 162 (3rd Quarter, 2014) (with Matthew E. Rappaport); "A Case for Simpler Gain Bifurcation for Real Estate Developers," 16 Fla. Tax Rev. 279 (2014) (with Nathan R. Brown & E. John Wagner, II).

8 See I.R.C. 7508A; Notice 2020-23, 2020-18 I.R.B. 1; Rev. Proc. 2018-58, 2018-50 I.R.B. 990.

9 See id.

10 See Treas. Reg. § 1.1031(k)-1(k).

ISSUES TO CONSIDER IN THE PURCHASE AND SALE OF A GROUND LEASED FEE ESTATE (WITH FORM)

KENNETH M. JACOBSON is a Partner with Katten Muchin Rosenman LLP, in Chicago. Ken has a well-honed ability to distinguish between peripheral issues that drain the time and energy of all parties, and deal terms that truly affect his clients' interests. He keeps his attention fixed on the latter. Together with his organizational skills and attention to process management, he is able to put his advice into action quickly.

In markets good and bad, Ken uses investment structures and product types that meet his clients' needs. His deals involve most sectors of the commercial real estate market, including offices, hotels, multi-family apartments, industrial buildings, and mixed-use facilities.

The purchase and sale of a ground leased fee estate[1] is much like the purchase and sale of other commercial real estate. However, whether or not the ground lease exists or is being created simultaneously with acquisition of the land to be leased under a newly created ground lease, the fact that the ground lease tenant will often have substantially all of the control of, and responsibility for, the property (including the improvements located on the property) will require further thought by a seller or purchaser. Among other things, the tenant's assets might be limited to the leasehold estate and improvements and, accordingly, the tenant might not have the ability (alone or through a lease guarantor) to perform its obligations under the ground lease other than through property income or the value of the leasehold estate. Thus, a ground lease fitting within such a paradigm bears resemblance to a non-recourse mortgage loan. The lender originating a non-recourse mortgage loan must be comfortable that the mortgaged property has sufficient income and value to support the mortgage loan because if there is a loan default, the non-recourse mortgage lender's recovery will likely be limited to acquisition of the property through foreclosure or a deed in lieu of foreclosure. The landlord under the ground lease must also be comfortable that the ground leased property has sufficient income-generating and value capabilities to support the tenant's obligations under the ground lease and understand that if the tenant defaults under the ground lease, the landlord's recovery will be limited to recovery of possession and control of the property by virtue of a termination of the tenant's rights in the leased property upon termination of the ground lease. Therefore, the ground lease landlord might analyze the acquisition of a leased fee estate or creation of a ground lease in much the same way that the lender of a non-recourse mortgage loan might analyze a non-recourse mortgage loan.

One might view the landlord's interest in a ground leased fee estate as the most senior part of the capital stack. The leased fee estate can be acquired in a variety of ways, including, the purchase of the leased fee estate subject to an existing ground lease (where the ground lease landlord is the owner of land), the sale to a third party of the improvements combined with the simultaneous creation of the ground lease (like a sale-leaseback transaction except the improvements and the fee estate in the land are separated) by the seller of the improvements, as ground lease landlord or where the purchaser of the entire "envelope" (land and improvements) bifurcates the acquisition at the closing by causing the land to be conveyed to a grantee that will become the ground lease landlord under a ground lease created simultaneously with the closing and causing the improvements, personal property, and space leases to be transferred to a different person at the closing simultaneously with the creation of a ground lease between the grantee of the land conveyance (i.e., the ground lease landlord) and the purchaser under of the envelope purchase and sale agreement. In the latter scenario, the ground lease landlord (i.e., the land purchaser) provides a portion of the capital required to acquire control over the entire envelope. An important difference is that, unlike the situation where the seller of commercial real estate deals only with the purchaser, in this latter scenario, the seller might deal (at least to some extent) with a separate (perhaps, unrelated), purchaser of the land. This can create an interesting dynamic involving as many as five parties: (i) the seller; (ii) the land buyer (ground lease landlord); (iii) the improvements and space lease purchaser (ground lease tenant); (iv) the leasehold mortgagee; and (v) a fee mortgagee—with the envelope purchaser simultaneously negotiating with some or all of these parties in order to buy the property, create the ground lease, and borrow the leasehold mortgage loan.[2]

Over the term of a long-term ground lease, it is not unreasonable to expect that the leased fee estate might trade several times. Sellers of leased fee estates are not unique in their desire to sell when compared to other sellers. They might want to redeploy capital to other investments, might need the funds to pay obligations, might desire to exit a market or business model, might have concerns about the viability of the tenant under the ground lease, might be prompted by an investment strategy that requires divestiture of assets at the end of any particular time period and a looming rent re-set may provide an opportunity to profitably cash-out of an investment without the necessity (at least for the seller) of a rent re-set process. Purchasers of leased fee estates may be prompted by a desire to obtain a relatively predictable income stream, a desire to deploy capital in particular markets or product types, the desire to obtain a potential increase in value that might arise out of a looming fixed rent re-set or, nearer to the end of the term of the lease, the right to obtain control of the entire property envelope by virtue of the acquisition of the residual interest of the landlord at the end of the term of the ground lease. The foregoing rationales to acquire or sell real estate are not exhaustive and conceptually do not differ significantly from motivations outside of the ground lease context. Purchasers of real estate might also view a ground lease as an opportunity to do some financial engineering in connection with the acquisition of the entirety of a property (i.e., the "envelope" alluded to above) by creating two estates; a leasehold estate and a fee estate, thus providing different avenues for capital providers to finance the acquisition of the entire envelope and (possibly) lowering the overall costs of funds required to acquire the income-producing components of the property. The following observations primarily focus on circumstances pertaining to an existing ground lease, but some of the observations may apply in connection with the creation of a ground lease under the envelope financial engineering circumstances mentioned above.

What does the leased fee estate purchaser acquire?

What exactly does the leased fee estate purchaser acquire? Typically, a purchase and sale agreement in a commercial real estate transaction will describe the assets that are to be purchased and will include the land, appurtenant easements, improvements located on the land, space leases of the land, personal property associated with the operation of the improvements, security and other deposits and, sometimes, service contracts related to the operation of the real estate. In the ground lease situation, the purchaser of the leased fee estate will generally purchase only the land, appurtenances to the land (e.g., appurtenant easements) and the landlord's interest in the ground lease itself. If the tenant owns the improvements and leases or otherwise conducts operations at the property, the seller will agree to convey only that which it owns (basically, the leased fee estate including the landlord's interest in the ground lease), which would not include the subleases through which the tenant will derive operating income. The purchaser of the leased fee estate will, as a general proposition, not have any need to acquire (or force termination of) service contracts as those are usually between the service provider and the ground lease tenant. As the landlord is generally not operating the property, it will likely not have employment relationships to deal with. Thus, the long list of property to be sold and acquired in a commercial real estate setting will likely be attenuated in the leased fee estate purchase. Conveyance documents may be limited to a deed conveying the land (expressly carving out the improvements if not previously carved out) and an assignment of the ground lease itself. The ground lease itself will typically address title issues pertaining to the status of title to improvements at the end of the ground lease term.

Pricing

A discussion of how one establishes the price that a purchaser might pay to purchase a leased fee estate or the base rent payable under a ground lease created at the closing is beyond the scope of this article. If the tenant is responsible for all of the property-related expenses, then as a general proposition the fixed rent is going to be absolutely net to the landlord. The analysis by the leased fee estate purchaser is analogous to the analysis by the purchaser of other commercial income-producing real estate, but with less emphasis on property-related expenses—those are mostly the tenant's responsibility in many ground leases. The existence of rent re-sets based upon changes in the consumer price index or other escalations are a positive factor for the leased fee estate purchaser. The existence of potential rent changes that could result in a reduction of fixed rent is a negative factor for the leased fee estate purchaser. The presence of a tenant purchase option may be viewed as setting limits on the purchase price that a purchaser of a leased fee estate would be willing to pay or the loan proceeds that a fee mortgagee would lend. The possibility of a fair rental value reset for fixed rent might be desirable for a leased fee estate purchaser, but care needs to be taken to fully understand the potential for a fixed rent reduction as well as developing a thorough understanding regarding the methodology, process, and timing of such reset and an analysis as to the ability of the ground lease tenant to pay potentially higher rents resulting from a re-set. The landlord under a ground lease with a long remaining term is generally passive, and given the control the tenant has over the property, it is the tenant who will be in the better position, during the term of the lease, to reap the lion's share of the income producing potential of the entire envelope. Given the long term of the ground lease and the substantial control of the site by the tenant during much of the term of the ground lease, there is little in the way of property enhancement that the landlord could do to generate increased rent for the landlord.[3] Nearer the end of the ground lease term, the possibility of the landlord capturing control of the property at the end of the lease term might drive a purchaser to be willing to pay more for the site, though if it intends to re-purpose the site, there may be entitlement, demolition, and development costs to consider.

The envelope purchaser considering the creation of a ground lease will consider whether the ground lease rental rate that it will pay under the ground lease when combined with the leasehold mortgage debt expense can, after payment of property expenses, be serviced by property income and will result in overall lower capitalization costs and higher returns (in effect, a form of leverage). So, the envelope purchaser will compare that structure to a capitalization structure where at least a portion of proceeds required by the leased fee estate purchaser are instead provided by a mortgage lender financing the entirety of the "envelope." If the leasehold mortgage lending market does not impose a huge premium on leasehold mortgage financing when compared to envelope financing, the splitting of the envelope into a fee estate and a leasehold estate might be attractive to an envelope purchaser. The ground lease interest purchaser will consider what it will pay for the rental stream (and, ultimately, for residual value at the end of the term) created under the ground lease (this analysis is similar to what many a purchaser of commercial real estate would do), but may also consider how the leased fee value relates to the value of the entirety of the envelope as well as the space lease (that is, the subleases under the ground lease) rental coverage to ground lease rent. Because ground lease rent must be paid in order to preserve the ground lease, the landlord enjoys a superior position in the capital stack, but the ability to "cover" the ground rent is important to a landlord that wants to be a passive recipient of ground rent and not be forced to operate the property itself. The parties will also need to take transactional costs into account in analyzing the envelope purchaser. For example, some jurisdictions may impose a transfer (or analogous) tax on the creation of the ground lease interest and inasmuch as the ground lease interest purchaser will want title insurance, instead of a single owner's policy insuring the entire envelope, there may be two owner's policies (one for the ground lease interest of the ground lease landlord and the other for the leasehold estate interest of the leasehold estate owner and possibly mortgage loan policies as well. There may also be the transactional costs associated with the review and negotiation of a ground lease to consider.

Selected diligence issues

Obviously, a review of the ground lease itself is front and center in connection with the diligence of the purchaser. Attached at the end of this article is a template for a ground lease summary review Form, which is from the perspective of the purchaser of a leased fee estate. It does not address every issue, but is set up to focus on a limited number of issues that should be considered by a potential leased fee estate purchaser early on in the acquisition process. It is not intended to be the basis for a deep dive into a ground lease, but rather is intended as a place to highlight important components of the ground lease from the perspective of the ground lease landlord. The footnotes that accompany the review form are designed to illustrate certain ground lease-related issues, (focusing on the perspective of the purchaser of the leased fee estate).[4]

The purchaser of the leased fee estate will be concerned about the ability of the leasehold estate to service the ground lease rent. In that sense, it is looking at this like the lender of a non-recourse mortgage loan. That is, it may want to understand the financial operation of the tenant and get a better understanding of the cash flow that will support the fixed rent payments. In this regard, the seller's diligence might include a review of operating statements for the tenant's operations and a rent roll of the tenant's subleases. It may further wish to review any subtenant non-disturbance agreements and related subleases. Thus, it would be helpful if the ground lease requires a tenant to provide its landlord with a rent roll, financial statements, and subleases for subtenants with the benefit of a non-disturbance agreement and does not include confidentiality restrictions that would unduly restrict the ability of the landlord to provide such items to actual or prospective purchasers, investors, and fee mortgagees.

The purchaser will also want to review the insurance requirements imposed under the ground lease and the actual policies or other evidence of insurance that the tenant is obligated to provide pursuant to the ground lease. Thus, the prospective purchaser will carefully review the insurance provisions of the ground lease and obtain the insurance information that the landlord is entitled to obtain from the tenant. Because the tenant is usually responsible for providing insurance, the landlord will need to get comfortable that its interests are adequately covered. If fee mortgage financing is to be obtained, the fee mortgagee will also need to get comfortable with the insurance to be provided by the tenant pursuant to the ground lease. Of concern might be specified limits on insurance matters (e.g., deductibles and liability insurances) that might have made sense years ago, but may no longer make sense.

Because the ground lease landlord is not typically responsible for property operations, it may not be entitled to obtain copies of subleases, service contracts, management agreements, licenses, and other property operational documents. Thus, the leased fee estate purchaser will often not be able to obtain access to those items. With respect to subleases in which the landlord has provided a non-disturbance agreement, as indicated above, the purchaser may wish to review the subleases inasmuch as a termination of the ground lease following the closing will create a direct landlord-tenant relationship. It would be helpful if the ground lease permitted the ground landlord to obtain copies of subleases from the tenant and be permitted to provide copies to the purchaser and its fee mortgagee. A ground landlord might look at these in a similar vein as a real estate mortgagee might look at an SNDA. That is, it will be stuck with whatever arrangements have been made between the sublandlord and subtenant following a termination of the ground lease.

The ground lease may limit the rights of the landlord to inspect the property during the term of the ground lease. Yet, purchasers will want to inspect the property and see for themselves what they are purchasing. It is helpful if the ground lease provides that actual and prospective leased fee estate purchasers (and their respective actual or prospective fee mortgagees) will be permitted to inspect the property. Furthermore, to the extent that access to the site is necessary for a land surveyor to prepare a plat of survey or for the preparation of an environmental site assessment, arrangements will need to be made to allow for such access. This is not really any different than in any other tenant-occupied property transactions, but there may be restrictions that will limit the ability of the surveyor or environmental engineering firm to access a site that will need to be addressed.

Ground leases typically impose the obligation on the tenant to maintain the improvements in compliance with applicable law and often in compliance with specified maintenance standards. Should the purchaser care about this before it purchases the leased fee estate? After all, if a problem arises after the acquisition, the rights and remedies of the landlord will dictate the result of non-compliance. On the other hand, the purchaser may be concerned about walking into an existing problem. Thus, the purchaser may very well care about compliance and the condition of the improvements and desire to obtain a zoning endorsement to its owner's title policy, a property condition report and a zoning report. Of course, the ability to obtain some of these items may be dependent upon the ability of the landlord and actual or prospective purchasers and fee mortgagees to access the property pursuant to the ground lease.

Pre-emptive rights

Ground leases, like other leases, may include pre-emptive rights such as rights of first refusal or first offer.[5] The leased fee estate purchaser will want these waived in writing before closing. This can be a tricky maneuver. If a right of first offer is involved, the purchaser may, if the tenant has passed on it, desire to see the notice to the tenant providing the offer and the waiver if the offer is waived and will want to confirm that the purchase agreement terms do not trigger a revival of any right of first offer or refusal. If the negotiations result in a reduction in the price below what was offered to the tenant (which might occur as a result of the purchaser's diligence), the purchaser may wish the tenant to again to confirm such waiver in writing, though the provisions of the ground lease pertaining to the pre-emptive right might include provisions that would allow for a price reduction equal to or in excess of the negotiated price reduction. If a right of first refusal is applicable, the purchaser should be aware that it might incur costs without necessarily getting the deal and may be concerned about the uncertainty involved in whether or not the deal will proceed. If the seller of the ground lease interest is relying on an exception to a preemptive right, the purchaser of the leased fee estate interest might still desire that the tenant confirm that the applicable pre-emptive right does not apply in the particular circumstances in question.

Title and survey

The purchaser of the leased fee estate is not unique in its desire to obtain "clean" title and an owner's title insurance policy insuring the leased fee estate and a plat of survey (much like the purchaser of other commercial real estate property). Title and survey review should be similar to that conducted for other types of commercial real estate acquisitions. The landlord's policy will include an exception for the ground lease, which, after all, is in practical effect what the purchaser is purchasing. Typically, the ground lease landlord does not have any responsibility relative to mechanics' lien clearance under a ground lease because the tenant is usually given the right to improve the property to the exclusion of the landlord and is responsible for maintaining the mechanics' lien free status of the leased fee estate. Mechanics' liens will typically attach to the improvements which are typically not part of the ground lease landlord's estate (except for any residual interest in the improvements at the end of the lease term). The ground lease will generally require the tenant to maintain the mechanics' lien-free status of the leased fee estate and the purchaser will typically insist that the leased fee estate be free and clear of those liens at closing. Suppose mechanics' liens get filed against the leased fee estate before the closing? Should the leased fee estate purchaser rely on the provisions of the ground lease relative to lien clearance? Like the issue of repair of casualty loss discussed below, timing is everything. Were the mechanics' lien to be filed after the closing, the ground lease's provisions would dictate clearance matters relative to such mechanics' lien. Does the purchaser want the headache even if the tenant is responsible? The filing of such mechanics' claims could be an indicator of problems on the tenant's side and perhaps the purchaser may want the ability to terminate the purchase agreement should the mechanics' lien claims exceed certain limits. From the seller's perspective, it doesn't want to be in a position where it is forced to remove a lien where it isn't at fault and where the ground lease may afford the tenant various mechanics' lien contest rights. What about encroachments? The leased fee estate purchaser usually does not acquire the improvements. To the extent removal of improvements is an issue, it is very much the ground tenant's issue. Yet, a fee estate purchaser doesn't wish to buy into a potential issue that could result in potentially significant impairment of the "security" afforded the landlord by the ground lease.

Representations, warranties, and executory period agreements

Because the tenant will typically own the improvements and have control over such improvements and the leased premises, the seller of the leased fee estate will resist providing representations and warranties to the purchaser in a purchase and sale agreement pertaining to property condition, subleases, property-related legal compliance, service contracts, and the like. This is similar to an "as-is" purchase paradigm, but, in the ground lease context, the leased fee estate seller (especially with an existing ground lease) might not be in a position to provide such information even if it desired to do so. The leased fee estate purchaser will insist on a representation and warranty as to the copy of the ground lease provided to it being the correct representation of the actual ground lease as well as containing all of the relevant agreements between the landlord and tenant. As in other commercial real estate contexts, the purchase and sale agreement can include provisions addressing the ability of the seller of the leased fee estate to amend or terminate the ground lease and provide consents to the tenant prior to the closing, but may also address the ability of the ground lease landlord (seller) to enter into non-disturbance agreements with subtenants (at least under circumstances where the ground landlord is not required to provide non-disturbance agreements pursuant to the ground lease).

In many instances, the leased fee estate purchase under an envelope arrangement, will not be benefitted by the representations and warranties of the envelope seller, but many of the issues that the representations and warranties cover will be addressed by title insurance on the leased fee estate and are the tenant's concerns as they pertain to the ability of the tenant to generate returns from the investment and costs and liabilities associated with the property, most of which are the responsibility of the tenant under the ground lease. The leased fee estate purchaser may need to obtain the benefits of owners' affidavits, Foreign Investment in Real Property Tax Act (FIRPTA) statements and gap undertakings which will need to be arranged by the envelope purchaser.

Prorations

What about prorations in the sale of a leased fee estate? In a ground lease where the tenant is responsible for all costs pertaining to the property and entitled to all of the income generated by the leasehold estate, the only item to prorate in many instances will be the fixed rent under the ground lease. This makes things simple. Of course, when the seller will become the landlord, the purchase agreement can provide for other prorations (e.g. ad valorem taxes for the period prior to the closing). As the purchaser of leased fee estate, one might be concerned about some items, such as ad valorem real estate taxes, that are a lien on the fee estate, but, because the tenant is responsible for payment of this expense, would not typically be prorated in connection with the sale of the leased fee estate. When the leased fee estate purchaser is brought into a deal where the tenant has entered into a purchase agreement to purchase the entire envelope, in many instances, the prorations under the purchase agreement for the purchase of the envelope should be between the envelope seller and the envelope purchaser (i.e., the tenant under the ground lease).

Security and other deposits

If the ground lease requires the tenant to provide a security or other deposit, the leased fee estate purchaser will want the seller to provide it with a credit for the amount of any unapplied cash security or other deposit against the purchase price and for letters of credit serving as security, it will want the security deposit assigned to it. In that sense, the leased fee estate purchaser views these deposits in a similar manner as the purchaser of non-ground leased fee estate commercial real estate. If the space leases require space lease tenant security, that security will likely be assigned to the envelope improvements buyer rather than the leased fee estate purchaser (i.e., following the assignment of the subleases).

Capitalization contingency

When the purchaser is purchasing the leased fee estate, it will need to confirm during its diligence that the ground lease will satisfy the requirements of its fee mortgagee. This particular issue is not dissimilar to issues faced by purchasers in non-ground lease transactions in that the purchaser will be cognizant of the requirements of actual or prospective financing sources.

When the purchaser is purchasing the envelope or when the seller is selling the improvements and retaining title to the leased fee estate in connection with a ground lease created at the closing of the sale of the improvements, the tenant will be cognizant of the need to satisfy its leasehold mortgagees' requirements relative to the ground lease that is being created at the closing. When the envelope purchaser is splitting the fee estate and leasehold estate at its closing, this may necessitate negotiation of a ground lease or provisions in a ground lease concurrently with negotiations with the leasehold mortgagee.

Assignment

Many purchase and sale agreements limit the ability of the purchaser to assign the purchase and sale agreement. When the purchaser is purchasing the ground lease, the purchaser and fee estate seller will have concerns regarding assignment of the purchase and sale agreement for the fee estate. When there is a purchase of an envelope, the envelope purchaser will want title to the land to go to the leased fee estate purchaser and will want the improvements, leases and other property-related assets to go to the purchaser or its assignee. Of course, the envelope purchaser could acquire the entirety of the property and contemporaneously with the closing of the acquisition of the envelope convey the land to the leased fee estate purchaser and enter into the ground lease. This might require payment of a transfer (or analogous) tax in connection with the sale of the envelope and payment of another transfer (or analogous) tax in connection with the purchase of the leased fee estate by the leased fee estate purchaser.[6] The envelope purchaser might consider provisions in its purchase and sale agreement that would allow for a partial assignment of the purchase and sale agreement to the fee estate buyer or a direct conveyance to a designated leased fee estate grantee. Some envelope sellers may be skittish about the potential for dealing with unknown parties under those circumstances. Viewed as capitalization device, the designation of a fee estate buyer is (somewhat) analogous to the potential lending arrangements that purchasers of commercial real estate deal with. The envelope purchaser would ideally like to include provisions in the purchase and sale agreement to allow for space tenant estoppel certificates to be relied upon by the leased fee estate purchaser, but, whether that is feasible will often depend on the terms and provisions of the space leases themselves. On the other hand, the space lease estoppels should be of more use to the ground lease tenant than the ground lease landlord.

Estoppel certificates

Getting an estoppel certificate from the ground lease tenant is important to the leased fee estate purchaser for reasons analogous to those applicable to other commercial real estate transactions with non-residential tenants. Like many non-ground lease transactions, the ground lease can limit the information that the tenant is required to provide in an estoppel certificate. The leased fee estate purchaser will, among other things, likely want confirmation as to the accuracy and completeness of the ground lease, the current amount of fixed rent, the commencement and termination dates of the lease (particularly, if not clear from the four corners of the ground lease itself), and the absence of default by the landlord. These are not unusual requirements. What may be difficult is getting confirmations regarding the derivation of the fixed rent if it is subject to adjustments that are not readily determinable from the four corners of the document (e.g., Consumer Price Index adjustments). Lease amendments accomplished through certifications to tenant estoppel certificates might not be effective to amend the ground lease or bind subsequent tenants and if an amendment is to be obtained, the purchaser, seller, and tenant will need to give thought as to the appropriate document in which to effect the amendment. What about seller estoppel certificates in place of an estoppel certificate from the tenant? The analysis is similar to the analysis in other commercial real estate contexts, but the leased fee estate purchaser (like the purchaser in other commercial real estate transactions) ordinarily prefers to hear directly from the tenant in the form of an estoppel certificate provided by the tenant. To the extent that the leased property derives income from commercial tenants, the leased fee estate purchaser might consider obtaining estoppel certificates from commercial subtenants, but sellers of leased fee estates are reluctant to do so as they must go through the tenant and the ground lease might not contemplate this possibility. What about estoppel certificates from CCREA parties? Typically, the tenant will be responsible for performance, but the leased fee estate purchaser may nonetheless desire comfort that the tenant has been complying.

Casualty and condemnation

Is there an argument to treat casualty loss and condemnation occurring during the period between the signing of the purchase and sale agreement and the closing differently than in the non-ground lease context? Ground leases usually address how casualty loss and condemnation are to be treated. Should a casualty occurring the day before the closing be treated differently than a casualty that occurs the day after the closing? The seller will argue that the leased fee estate purchaser is, in effect, buying the ground lease. When the tenant is obligated to repair the casualty loss and where insurance proceeds are required for such purposes, such an approach might be logical. On the other hand, when the tenant might be able to terminate the ground lease, when the tenant is not obligated to restore the loss, when insurance proceeds are not required for restoration, when the tenant may be entitled to abate rent or where key subtenants might be able to terminate their leases, the purchaser might nonetheless decide to take a pass on closing. In addition, even when the tenant is obligated to restore and proceeds will be available for restoration, the purchaser might decide that the aggravation, possible uncertainty, and perhaps additional oversight over the restoration process is a reason to move onto the next deal and terminate the purchase and sale agreement. Thus, there may be reasons to continue incorporating casualty loss and condemnation provisions in the purchase and sale agreement analogous to those outside the context of a ground lease purchase.

Closing documents

The closing document deliveries should include a deed conveying the land to the leased fee estate purchaser and in the case of an envelope transaction, a deed conveying the improvements to the ground lease tenant. In the ground lease context, the tenant owns the improvements and the improvements will not be conveyed by the deed conveying the leased fee estate. In the context where the ground lease might be created at the time of the acquisition of the land, the deed to the ground lease purchase would exclude the improvements from the real estate being conveyed. The leased fee estate purchaser will likely not be acquiring any tangible personal property and, accordingly, a bill of sale would not be provided by the seller as the personal property is most relevant to the tenant. Similarly, the only lease that the leased fee estate seller is assigning would be the ground lease itself rather than the subleases arising under the leasehold estate.[7] If the transaction is one where a ground lease is being created at the closing, the tenant will want a memorandum of lease recorded memorializing the ground lease and, if a pre-emptive right is included in the ground lease, it may want the pre-emptive right reflected in the memorandum.[8] To the extent that the pre-emptive right is a "use it or lose it" right, the ground lease might also provide for an amendment of the memorandum eliminating the recorded reference to the pre-emptive right if the tenant "passes" and the sale of the leased fee estate in concluded within the applicable parameters in the ground lease.

Final thoughts

This article does not address every issue that a ground lease interest purchaser or seller might consider. The analysis of purchase and sale of a ground leased interest is similar to analysis ordinarily undertaken for other commercial real estate purchases. However, due to the nature of the ground lease with its concentration in the ground lease tenant of property control and operational economics, the leased fee estate purchaser should give additional thought to how it structures the transaction, conducts its diligence, and proceeds to closing.

Notes

1 A ground lease is typically a lease of the land and excludes the improvements located on the land, which are typically owned by the tenant. Some of the observations which follow might apply as well to long-term leases of the land and improvements where the improvements are owned by the landlord, but where the tenant has substantially all of the responsibility for the repair, maintenance, restoration, improvement, and operation of the improvements.

2 Perhaps, with the addition of contemporaneous mezzanine loans and equity raises, including additional relationships.

3 Of course, the landlord could offer to finance property improvement (re-development) either through a tenant improvement allowance, loan, or rent adjustment, but, while this could ultimately result in an increase in the fixed rent that the tenant is prepared to pay, it requires the tenant's agreement. Such investments by the landlord are "repaid" with a return based upon specified rates with increases in property value inuring to the tenant (somewhat like the increase in property value arising out of use of construction loan proceeds).

4 Of course, the substance and tenor of the commentary the Form would likely be different if the review form were intended to address issues of concern to the purchaser of a leasehold interest.

5 Space leases tenants might also have pre-emptive rights to be considered if the space leases predate the ground lease.

6 Some jurisdictions might also impose a tax on the creation of the ground lease leasehold estate.

7 An exception would be in connection with an envelope purchase, where the space leases would be assigned to the purchaser of the improvements.

8 Most ground leases will be memorialized in the applicable real property records by recording a memorandum of lease of ground lease anyway.

FORM

The purpose of the following chart is to facilitate a review of a ground lease from the perspective of the purchaser of a leased fee estate. The paradigm for the chart is a parcel leased to a commercial real estate ground lease tenant with the existing improvements located on it owned by the tenant.

Ground Lessor-Centric Short Form Ground Lease Summary

CONFIDENTIAL/NOT TO BE DISCLOSED

THIS IS A SUMMARY OF CERTAIN FEATURES OF A LENGTHY AND COMPLEX DOCUMENT AND IS NOT A SUBSTITUTE FOR A REVIEW OF THE DOCUMENT ITSELF.

Asset	
Reviewer	[Name, Contact Information]
Date of review	
Lease and amendments[1]	
Term and extensions/Early termination rights[2]	
Fixed rent [Escalations/re-sets][3]	
Entitlements/Construction[4]	
Bond type [Limitations on tenant responsibility and landlord obligations][5]	
Setoff/Rent abatement[6]	
Tenant reporting[7]	
Tenant purchase options (including pre-emptive rights such as rights of first refusal) and limitations on transferability of the fee estate[8]	
Limitations on fee mortgages and landlord financing[9]	
Condemnation[10]	
Casualty/insurance[11]	
Estoppel certificates[12]	
Landlord access[13]	
Confidentiality[14]	
Change in use[15]	
Demolition/alteration[16]	
Insurance[17]	
Tenant rights to assign, sublet and enter into leasehold mortgages[18]	
Other items of note[19]	
Missing items	

1. Identify the Lease and each amendment by title, date, and parties. If an item appears to be missing, it should be noted in the "Missing items" row.

2. The initial lease term should be indicated with a calculation of the remaining term. If there are options to extend the term, the duration, advance notice and, if applicable, rent re-setting of or for the extensions should be noted. If the termination dates are not determinable from the face of the reviewed documents, that should be noted. Any termination rights (especially those in favor of the Tenant) should be noted. Ideally, from the landlord's perspective, the tenant should not have the right to terminate the term before the scheduled expiration date. If termination due to casualty or condemnation is a possibility, the threshold and conditions for such termination should be described.

3. The fixed rent is often ascertainable from the body of the document, but, if fixed rent adjustments are tied to changes in the Consumer Price Index or other items, such facts should be noted in detail to facilitate tracking the derivation of fixed rent (this might ultimately be confirmed through a tenant estoppel certificate). If rent adjustment dates are not determinable from the four corners of the lease, that should be indicated. Ideally, from the landlord's perspective, fixed rent should escalate periodically and the reviewer should indicate how the escalations are determined. That is, if there are escalations, those should be indicated. If escalations are based upon changes in a Consumer Price Index, such fact should be noted along with a description of the frequency of such changes as well as limitations (e.g., ceilings) and floors on such increases. If rent is subject to periodic re-set due to valuations or otherwise, such fact should be noted as well as a description of the frequency of the re-set, calculation and process for determination of such re-sets, standards applicable to the determination of the re-set rent, and limitations on such re-sets (floors and ceilings). Ideally, from the landlord's perspective, fixed rent does not get reduced over time for any reason. From an underwriting standpoint, it is critical that the rent pro forma rents be compared to the actual words in the lease documents.

4. To the extent ascertainable from the lease, indicate whether the project is in the initial entitlement or initial construction stage. If the reviewer is advised that the project is under construction or is in the initial entitlement stage, that should be indicated. If the initial project is in the entitlement or construction phase, indicate whether the landlord has any financial or construction obligations with respect to such entitlements or construction (the status of these will presumably be addressed in a tenant estoppel certificate) and whether there is any tenant (or landlord) provided security (including a guaranty) relative to such project as well as timelines (if any) for completion.

5. The reference to "bond type" does not refer to the financial wherewithal of the Tenant, but rather to the all-encompassing obligation of the tenant to pay all expenses and costs associated with the property during the term.

   Ideally, from the landlord's perspective, the tenant should be responsible for all costs and expenses, capital or otherwise, including real estate taxes and assessments pertaining to the property during the term of the lease. Limitations on the obligations of the tenant, including limitations that do not require the tenant to expend capital to maintain the property to comply with applicable law should be indicated.

   Ordinarily, the tenant keeps the leased fee estate free and clear of mechanics' lien claims, but may have rights to contest those liens. Typically, the fee estate should not be subject to mechanics' lien claims arising out of the tenant's actions.

6. Any right of the tenant to abate or setoff rent should be indicated. Ideally, from the landlord's perspective, the tenant should not have the right to setoff or abate rent with the possible exception of rent

adjustments to accommodate condemnations occurring during the term that do not result in termination of the lease (but, ideally, the landlord will be compensated from the award for the value of the condemned leased fee estate).

7. Describe tenant's reporting obligations. Ideally, from the landlord's perspective, the tenant is obligated to provide, at a minimum, annual financial statements, preferably audited and, if not audited, whether or not the landlord has the right to require them if it is prepared to pay the cost of the audit. Furthermore, ideally, from the landlord's perspective, the tenant should be obligated to provide rent rolls of its subleases. The financial reporting by the tenant should allow the landlord and its prospective fee mortgagees and purchasers some ability to determine the cash flow coverage of the ground lease fixed rent afforded by the tenant's operations.

8. Any right of the tenant to purchase the leased fee estate should be indicated. If the tenant has a purchase option, indicate whether or not the file also includes evidence that the tenant has provided a mortgage to the landlord in the event that the lease is re-characterized as a mortgage, what the purchase price is and whether, if at all, the purchase price is to be grossed up to cover fee mortgage payoff amounts. If the tenant has a right of first refusal or right of first offer, such fact should be noted. Ordinarily, the landlord will prefer that the tenant not have any right or option to purchase the fee estate. If the tenant has a purchase option the description should include any limitations on such option, the circumstances that trigger the option, the notice required for the exercise of such option, the purchase price (or the methodology used to calculate the purchase price), responsibility for closing costs, the landlord's title clearance obligations, and the treatment, if any, of fee mortgages (discuss whether there is an explicit or implicit limit on the landlord's ability to finance the fee estate by virtue of the purchase option). With regard to rights of first refusal, rights of first offer, or other pre-emptive rights, discuss the trigger for the exercise of such rights by the tenant, any required contents for such offer, whether there are any exclusions (e.g., portfolio sale or affiliate transfers), the notice and time periods required to consider the offer and close on the offer if accepted, how such right can be waived, the extent to which a waiver by the tenant waives such right forever (including, a discussion of any obligation of the landlord to remake the offer following a waiver), and how a waiver is to be evidenced.

9. Indicate whether or not there are limits on the landlord's ability to mortgage the fee estate, whether the lease requires "subordination" of the leased fee estate, and whether or not the lease includes attornment provisions. As a working assumption, each fee mortgage will be "subordinate" to the leasehold estate, but any leasehold mortgagee would, if it were to foreclose or take an assignment in lieu of foreclosure, acquire only the leasehold estate and not any part of the fee estate. That is, if the fee mortgage were to be foreclosed (or should there be a conveyance in lieu of foreclosure of the fee estate), the foreclosure sale purchaser or grantee of a deed in lieu of foreclosure takes title to the leased fee estate subject to the ground lease (in effect becoming the new landlord) and, if the leasehold mortgage were to be foreclosed (or should there be an assignment in lieu of foreclosure), the leasehold mortgage foreclosure purchaser or assignee in lieu of foreclosure would become the new tenant.

10. Describe the consequences of condemnation with respect to termination of the lease, adjustment of the fixed rent, and the sharing of the award. Ideally, from the landlord's perspective, the lease will not be terminable except by virtue of a taking of all or substantially all of the premises, the rent will not abate unless the landlord receives an award for the value of the portion of the fee estate taken, and the landlord will get the value of its fee estate first (calculated based upon the greater of the estate as encumbered or unencumbered at its highest and best use) with the tenant obligated (if the ground lease is not to be

terminated) to use the award it gets to repair and restore the damage occasioned by the condemnation without regard to the adequacy of the award.

11. Describe the consequences of a casualty with respect to termination of the ground lease, abatement of the fixed rent, use of insurance proceeds, and the obligation to restore. Ideally, from the landlord's perspective, the ground lease will not terminate on account of a casualty, there will not be any abatement of fixed rent, insurance proceeds are to be used to repair and restore the damage occasioned by the casualty, and the tenant will be obligated to repair and restore the damage without regard to the adequacy of insurance proceeds.

12. Indicate whether or not estoppel certificates are required from the landlord and tenant, the contents of such estoppel certificates, and any limitations on the ability of the landlord to obtain an estoppel certificate from the tenant. Note that applicable law might not allow for lease amendments via estoppel certificates, but may require "formal" lease amendments.

13. Indicate whether or not the landlord (and those designated by it such as surveyors, environmental site assessment preparers, and actual or prospective fee mortgages and investors) can enter and inspect the premises.

14. Indicate whether or not there are limits on the ability of the landlord to share reports and information provided by or on behalf of the tenant.

15. Describe the ability of the tenant to change the use permitted under the ground lease and to alter the premises without the consent of the landlord. A working assumption is that the tenant will have robust rights to alter the property so long as the alterations comply with applicable law, do not change the use permitted under the ground lease and there are adequate assurances of performance.

16. Indicate the degree to which the landlord's consent is required for demolition or alteration of improvements and the extent to which the tenant must demonstrate ability to pay the costs of improvements and provide assurances to the landlord of the tenant's ability to complete the improvements.

17. Indicate what insurance is required to be provided by the tenant. Ideally, from the landlord's perspective, the tenant is obligated to provide casualty insurance for the improvements at full replacement cost (builder's risk if construction activity) and liability insurance as well as a catch-all obligation to provide insurance that are then generally obtained for similarly situated properties (or concepts of similar import).

18. The working assumption is that tenant will have relatively robust rights to assign, sublet, and mortgage the leasehold estate. However, it is also a working assumption that the relatively robust rights to assign and sublet will often be restrained before completion of initial improvements. Further, it is also a working assumption that the leasehold mortgagee will, so long as it is an institutional lender and not an affiliate of the tenant, have customary leasehold mortgagee protections rights, including: (i) the right to cure tenant defaults; the right to foreclose its leasehold mortgage or take an assignment in lieu of foreclosure without the landlord's consent; (ii) no obligation to cure defaults that are inherently not susceptible to cure upon acquisition or control of the leasehold estate; (iii) no obligation to cure defaults that require possession in order to effect a cure until possession is obtained; (iv) the right to a new lease on the same terms (but, with the same scheduled expiration date and an obligation to cure defaults) if the ground lease is terminated (or rejected in bankruptcy); (v) no merger of fee and leasehold estate; (vi) the right to be the proceeds trustee for the purpose of holding and disbursing insurance proceeds and condemnation awards; and (vii) leasehold mortgagee right to exercise option on behalf of the tenant, etc. Thus, these

provisions need not be described if they fall within the paradigm (however, affording leasehold mortgagee protections to mezzanine lenders might be less common and should be noted).

Provisions that require the Landlord to sign non-disturbance agreements for the benefit of subtenants should be identified.

19. What is described for this category is something of a judgment call. Certainly, the landlord's obligations to pay expenses, construct improvements, or to pay a portion of the cost of improvements should be indicated to the extent not addressed elsewhere in the summary.

    An additional working assumption is that the improvements need not be removed by the tenant at the end of the lease term and that title to the improvements will vest in the landlord at the end of the term and, accordingly, the reviewer should indicate if the working assumption does not apply in these circumstances.

    If there is security provided by the tenant (e.g., security deposit) or a guaranty, that information should be included to the extent not provided elsewhere in the summary. Sometimes security or guarantees are provided by tenants before completion of the initial improvements or during material demolitions or alterations.

    A working assumption is that most defaults by the tenant will require notice and expiration of a robust cure period before an event of default permitting termination of the ground lease or the tenant's right of possession. If the ground lease provides for a second "last clear chance" notice and opportunity to cure or limitations on the landlord's right to terminate the ground lease or possession to narrowly defined circumstances, such fact should be noted.

    To the extent that the landlord has or does not have self-help rights to pay taxes and mechanics' liens that encumber the fee estate, such facts should be noted.

LIQUIDATED DAMAGES IN COLORADO PURCHASE AND SALE AGREEMENTS

JESSE D. SUTZ is an Associate with Brownstein Hyatt Farber Schreck, LLP, in Denver. He approaches his clients' legal issues meticulously and with a sense of pragmatism. Although early in his career, he has a broad range of representative experience, handling an array of client issues including real estate and employment matters.

During law school, Jesse was an articles editor on the Emory Law Review, a judicial extern for current Justice Michael Boggs when the judge served on the Georgia Court of Appeals, an extern at the Department of Justice, and a teaching assistant for first-year torts students. Jesse graduated in the top five percent of his class.

This article discusses Colorado law on liquidated damages in the context of commercial real estate purchase and sale agreements. In Colorado, liquidated damages are the customary, exclusive remedy for a default by the buyer.[1] There are no statutes controlling the validity or requirements of liquidated damage provisions. Rather, the jurisprudence surrounding liquidated damage provisions exists in the state's common law.

The most important piece of Colorado jurisprudence on liquidated damages is the Colorado Supreme Court case, Ravenstar, LLC v. One Ski Hill Place, LLC,[2] wherein the Court held that a liquidated damage clause in a contract is not invalid as a penalty solely due to the fact that the contract gives the non-breaching party (in this case, the seller) the option to choose between liquidated damages and actual damages.

1. May the seller elect to seek a remedy of specific performance of a purchase and sale agreement?

Generally speaking, a seller may choose specific performance if the buyer fails to perform and the seller proves it was willing and able to perform. Clark v. Scena,[3] (discussing that once the buyer and seller enter into a binding agreement, the non-breaching party can seek specific performance if it shows it was willing and able to perform). Because of Colorado's adherence to principles of freedom of contract, so long as the contract does not limit the seller's right to specific performance, the seller would likely be able to pursue this equitable remedy.

2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive damage remedy)?

In Colorado, liquidated damages need not be the exclusive remedy in a purchase and sale agreement, and parties may freely contract for an option to pursue liquidated damages or actual damages in the event of a breach.[4]

In Ravenstar, the breaching party argued that the non-breaching party's option to choose between two alternative damage remedies negated the element of mutual intent, which is one requirement of an enforceable liquidated damages provision.[5] The Court disagreed. Based on freedom of contract principles, the Court determined that "[t]he parties must only mutually intend to make liquidated damages one of the available remedies that the non-breaching party could pursue."[6] Thus, having the option to elect one of the two remedies does not negate the intent of the parties to include liquidated damages in the agreement.

Contractual provisions that include an option for liquidated damages or actual damages are valid and enforceable pursuant to Ravenstar. However, a party electing to pursue one available remedy might not also pursue the alternative remedy.[7]

3. If the seller may choose liquidated damages or actual damages, may it have both?

When a contract provides for an option between liquidated damages and actual damages, the non-breaching party cannot collect both because liquidated damages serve as a contractual substitute for actual damages. Id. The Colorado Supreme Court held in Ravenstar that "[i]f the non-breaching party elects to pursue the liquidated damages set forth in the contract, it may *not* in addition pursue the alternative actual damages remedy."[7] (emphasis added). The Court went further to state that if the non-breaching party could also pursue the alternative damages remedy, then "an election to pursue liquidated damages would function as an invalid penalty."[9]

Importantly, if a liquidated damages clause is held to be unenforceable, a party may still seek actual damages.[10]

4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

The non-breaching party will need to elect to pursue liquidated damages or actual damages before filing suit against the breaching party, or as otherwise provided in the contract.[11] Beyond that, the question as to when the election must be made remains unresolved. However, based on Colorado courts' deference to freedom of contract principles, the language of the contract would likely control. In the event there is no such language, Ravenstar would likely control, and election would need to be made prior to filing suit.

5. Is there an applicable statute addressing liquidated damages clauses?

Colorado does not have a statute addressing liquidated damages. Rather, the test for liquidated damages derives from common law.

6. What is the test for a valid liquidated damages clause?

In Colorado, a provision for liquidated damages will be upheld unless it operates as a penalty. See, e.g., Klinger v. Adams Cnty., Sch. Dist. No. 50,[12] (citing Restatement (Second) of Contracts § 356(1) (1981)). The determination of whether a liquidated damages provision constitutes a penalty is a question of fact.[12]

A liquidated damages provision is not characterized as a penalty, and thus enforceable if: (i) the parties intended to liquidate damages; (ii) the amount of liquidated damages, when viewed as of the time the contract was made, was a reasonable estimate of the presumed actual damages that the breach would cause; and (iii) when viewed again as of the date of contract, it was difficult to ascertain the amount of actual damages that would result from a breach.[14] (finding that a provision for liquidated damages in the amount of $20,000 for the breach of a $425,000 real estate purchase and sale agreement was legally enforceable).[15] Issues regarding whether a liquidated damages provision constitutes a penalty generally revolve around the second element—whether the amount of liquidated damages is reasonable in proportion to the anticipated actual damages.

7. Who has the burden of proof?

Unless the contract establishes on its face that liquidated damages are so disproportionate to any potential, actual loss—as to constitute a penalty—the party challenging the liquidated damages provision bears the burden of proof.[16]

8. As of when is "reasonableness" tested?

The "reasonableness" standard is applied as of the time the contract is entered into.[17]

9. What percentage of the purchase price is likely acceptable as liquidated damages?

There is no mathematical or mechanical formula that can be applied in every case. Rather, liquidated damages must be reasonable and not vastly disproportionate to the anticipated loss or injury.[18] A contractual provision for liquidated damages is invalid as a penalty if it is unreasonably large in proportion to the expected, actual loss from a breach of contract.[19]

10. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

To be enforceable, the stipulated amount of liquidated damages must bear a reasonable relationship to the presumed actual damages that the breach would cause.[20] Therefore, actual damages may be relevant in determining whether the amount of the liquidated damages was reasonable when agreed upon. For example, if there are no actual damages, the agreed-upon amount of liquidated damages may be proven to be unreasonable and thus, the liquidated damages might not be allowed.

11. Is mitigation relevant for liquidated damages?

Colorado has not determined whether a party has a duty to mitigate liquidated damages. However, Colorado's implied covenant of good faith and fair dealing can give rise to a duty to mitigate liquidated damages. See Amoco Oil Co. v. Ervin,[21] (every contract includes an implied covenant of good faith and fair dealing). Cf. Medema Homes, Inc. v. Lynn,[22] (liquidated damages for delay in home purchase contract will not be enforced where party seeking damages caused such delay).

12. Is a "shotgun" liquidated damages clause enforceable?

Colorado does not have any statutes or case law specifically addressing "shotgun clauses" which fix a single large sum as the liquidated damages for any breach. However, given Colorado's requirement that the liquidated damage amount bear a reasonable relationship to the actual damages that could arise from the breach, a Colorado court would most likely find a shotgun clause unenforceable because the amount of damages would not be structured to bear a reasonable relationship to the damages caused by the breach. See Oldis v. Grosse-Rhode,[23] (holding a liquidated damages provision providing that all payments made by the buyer must be forfeited by the buyer, regardless of whether they constitute one percent or 99 percent of the total purchase price, is void and unenforceable because under many circumstances the provision may result in an unconscionable forfeiture).

13. Does a liquidated damages clause preclude recovery of attorneys' fees by the seller?

Liquidated damages do not preclude recovery of attorneys' fees. See Ravenstar, LLC v. One Ski Hill Place, LLC,[24] (affirming trial court's award of attorneys' fees in action to enforce liquidated damages clause).

Notes

1 See generally 9 Colo. Prac., Creditors' Remedies - Debtors' Relief § 5:59.

2 Ravenstar, LLC v. One Ski Hill Place, LLC, 401 P.3d 552, 554 (Colo. 2017).

3 Clark v. Scena, 83 P.3d 1191, 1194 (Colo. App. 2003).

4 Ravenstar, supra, 401 P.3d at 553.

5 Id. at 554.

6 Id. at 556.

7 Id.

8 Id.

9 Id.

10 Hirsch v. Saad, 2018 Colo. Dist. LEXIS 2814, at *62 (citing Yerton v. Bowden, 762 P.2d 786, 788 (Colo. App. 1988)).

11 Ravenstar, supra, 401 P.3d at 553–554.

12 See, e.g., Klinger v. Adams Cnty., Sch. Dist. No. 50, 130 P.3d 1027, 1034 (Colo. 2006).

13 Id. at 1034 (citing Rohauer v. Little, 736 P.2d 403, 410 (Colo. 1987)).

14 Rohauer v. Little, 736 P.2d 403, 410 (Colo. 1987).

15 See also Ravenstar, supra, 401 P.3d at 552.

16 Rohauer, supra, 736 P.2d at 410 (citing Chisholm v. Reitler, 352 P.2d 794 (Colo. 1960)).

17 See Ravenstar, supra, 401 P.3 at 555.

18 Perino v. Jarvis, 312 P.2d 108, 109 (Colo. 1957).

19 Bd. of Cnty. Comm'rs of Adams County v. City & Cnty. of Denver, 40 P.3d 25, 32 (Colo. App. 2001).

20 See Rohauer, supra, 736 P.2d at 410.

21 Amoco Oil Co. v. Ervin, 908 P.2d 493, 498-99 (Colo. 1995).

22 Medema Homes, Inc. v. Lynn, 647 P.2d 664, 667 (Colo. 1982).

23 Oldis v. Grosse-Rhode, 528 P.2d 944, 947 (Colo. App. 1974).

24 Ravenstar, LLC v. One Ski Hill Place, LLC, 405 P.3d 298, at 306-07 (Colo. App. 2016).