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State of the Real Estate Market

By: Barry P. Rosenthal and Kenneth G. Lore

We are writing this article as we finish up our law firm's annual retreat, sitting with our 30 real estate partners from around the country, trying to plan for the coming fiscal year. In seeking to identify trends, we find conflicting signals. The general consensus is that there is no consensus. Our clients are anxious; and the markets are volatile. Everyone is looking to do a deal, make a loan, start a project, buy distressed assets; but there is reluctance to pull the trigger—the price is too high, the cap rate too low, the vacancy too high, the leasing too soft, the market fundamentals too weak, and the distressed assets are not distressed enough to earn the hoped for returns.

On the positive side, we are experiencing the lowest interest rates we have experienced in our careers. For the right borrower and structure, debt financing is plentiful, particularly from banks and life companies, and in multifamily housing, from the GSEs. There is lots of capital looking to make equity investments. Demand for multifamily housing in the major urban markets is strong, with prices in many cases at record low cap rates. It is not a bad time to be selling fully-leased, trophy office buildings.

But there is also angst in the markets, and concern not just with the domestic economy but with the broader world situation. While multifamily rentals are strong, the residential single family homeownership market shows no signs of returning to its former health. Unemployment remains high; the best minds in the country search for a way to generate jobs, and (so far, at least) we are not making much progress. The economy is weak, and the fear is that it will remain so for an indeterminate time. Added to this is the uncertainly of future federal tax policy as concerns real estate, particularly imposition of a so-called "carried interest" tax.

So how does this translate into our practice, and what are the issues that we see in the months ahead. Here are a few observations.

- There is an abundance of equity and debt financing available—if you are the right owner, having the right property type, properly structured, in a desirable market. But, underwriting structures have become much more stringent. Cash flow from credit tenants under long-term leases is valued, while vacant space is accorded little, if any value. Location always is important. Core properties are attractive. But character and reputation are equally important. And, don't incur too much leverage.
- The need to lease space is at a premium, and really a requirement to maximize sales price and loan proceeds. The cost of re-tenanting a building is expensive, and no owner wants to

CONTINUED ON PAGE 6

IN THIS ISSUE

Retail Leases in Bankruptcy and Reorganization Proceedings

By Maurice H. Sullivan, III, Steven Wilamowsky and Henry S. Healy

When the economy runs into trouble, owners of commercial properties are brought face-to-face with a host of unpleasant surprises, not the least of which is discovering what happens to lease obligations when a retail tenant becomes involved in bankruptcy or reorganization proceedings. This has been particularly significant in the current recession, where a number of national retail chains have failed. An aspect of the current recession that makes these concerns acute is the severe slump in real estate prices, which means that any existing lease is likely to be above market. In the past, many landlords were only too happy to take back leases from bankrupt retail tenants because of the opportunity to rent to a new tenant for higher rent. Unfortunately, this opportunity is rare under current conditions.

BANKRUPTCY BASICS

A bankruptcy case can be commenced by the filing of a voluntary proceeding by the debtor or by the filing of an involuntary proceeding by creditors of the debtor. In a "Chapter 7" liquidation proceeding, a trustee appointed pursuant to the Bankruptcy Code collects and liquidates all assets of the debtor's estate. The proceeds are then distributed to creditors. In a "Chapter 11" reorganization proceeding, the debtor usually continues to operate its business as "debtor in possession" and has all the powers and duties of a trustee unless otherwise ordered by the Court.[1] For a specified period, the debtor has the exclusive right to formulate a plan of reorganization, which must be approved by its creditors and the Bankruptcy Court in order to become effective.

Upon the filing of a petition for relief under Chapter 7 or 11 of the Bankruptcy Code (commonly referred to as the "Petition Date"), there is an automatic stay of lawsuits and any collection or lien enforcement activities by creditors against the property of the debtor. The stay includes any action by a landlord to terminate a lease. Unless a party subject to the stay asks for and obtains relief from the Bankruptcy Court, the stay remains in effect until the case is closed or dismissed or a plan of reorganization is confirmed. The stay does not prevent the landlord from collecting rent from guarantors of the lease unless they are in bankruptcy themselves.

1 Because most bankruptcy proceedings involving larger retail tenants are Chapter 11 rather than Chapter 7 cases, and do not involve appointment of a trustee, in this article the party empowered to act on behalf of the estate will be referred to simply as the "debtor."

Note, however, that the Bankruptcy Code does not protect a tenant whose lease was terminated in accordance with applicable law prior to the Petition Date. In that case, the lease no longer exists and cannot be assumed. This places a premium on prompt landlord action once a retail tenant begins to show signs of financial trouble.

LEASES IN BANKRUPTCY — THE FUNDAMENTALS

The administrative powers that may be exercised by the Bankruptcy Court include the power to authorize the rejection, assumption, or assumption and assignment of "executory contracts," including unexpired leases. A fundamental premise of bankruptcy law is that unexpired leases often can be valuable assets of the debtor's estate that should be retained. A second premise is that some leases involve burdens that outweigh their benefits and should be rejected because they impair the ability of the debtor to reorganize. In most situations, it is the debtor who has the right to decide whether to assume or reject any given unexpired lease.

From the Petition Date until a commercial lease is assumed or rejected, the debtor is required to pay rent and common area charges and perform other tenant obligations under the lease. Unpaid obligations that were incurred prior to the Petition Date have unsecured claim status and are rarely paid in full. The debtor is not required to comply with lease provisions concerning the debtor's financial condition. In some cases, bankruptcy courts have relieved debtors of other lease obligations prior to assumption or rejection. Examples are cases where retail tenants have been permitted to "go dark" or conduct "going out of business" sales despite lease provisions to the contrary. Note, however, that in the case of shopping center retailers, lease obligations other than those relating to the tenant's financial condition are likely to be enforced strictly in accordance with the terms of the lease.

Most commercial leases contain clauses stating that a bankruptcy filing by or against the tenant is a default that gives the landlord the right to terminate the lease. Other leases contain provisions stating that defaults include the tenant's insolvency, or a change in tenant's financial condition, or inability to pay its debts as they come due. These provisions are commonly known as "*ipso facto*" clauses and are not enforceable once a bankruptcy proceeding has commenced.

CONTINUED ON PAGE 7

Community Benefit Agreements for Development Projects: Risks and Rewards

By Katherine B. Kimball

Over the past decade, Community Benefits Agreements (CBAs) have become a tool commonly used by developers and community representatives to negotiate issues related to proposed developments. The trend began with the landmark 2001 redevelopment that expanded the Staples Center in Los Angeles and has spread rapidly across the country. CBAs are attractive to both developers and community representatives for a variety of reasons, but they also present significant legal questions and risks that should be analyzed and considered on a case-by-case basis. CBAs have been used in a wide variety of developments including energy projects, transportation projects and urban redevelopment.

PARTIES

A CBA results from negotiations between a developer and a coalition of community organizations. The make-up of the community coalition is critical; it is difficult to ensure that appropriate community groups and activists are given a voice in the negotiations. The coalition should be a broad and representative group of parties and may include, among others, neighborhood groups, labor unions, housing rights advocates, environmental groups, religious leaders and small business owners. Typically, governmental entities are not parties to CBAs. Under the current architecture of CBAs, there is no mechanism or safeguard to ensure that those who negotiate "on behalf of the community" actually represent the community. This is problematic not only for community members looking to be fairly represented but also for developers who will receive greater assurance of community support if all constituencies are represented in the negotiation process. If some activists or community groups are excluded, and therefore are not signatories to the negotiated CBA, they are not precluded by the CBA from challenging the project.

The role that local municipalities play with respect to CBAs varies. In some instances, local government officials are not involved in the process at all. On the other end of the spectrum, local officials initiate and even take part in the negotiations, but are not parties to the resulting CBA. The reality is that local authorities and communities throughout the country are navigating the process of incorporating CBAs differently. As discussed below, government involvement in certain instances may run afoul of legal constraints on land use regulation imposed by the Supreme Court and various state statutes.

BENEFITS

Community support (or at least a lack of community opposition) is an integral component of a developer's application to local authorities to obtain necessary approvals. Community opposition may discourage regulatory bodies from approving the project or substantially delay the development. Bad publicity, delayed permitting, and protracted negotiations and litigation can substantially increase the overall cost of a development and can cause problems for a developer who is trying to acquire project financing. For these reasons, developers place a high value on confidence that a project will move forward. Accordingly, the support of local community groups and activists is extremely valuable.

CBAs are an attractive tool because they can be molded to fit particular developments and specific community needs. Community coalitions can negotiate a wide range of individualized benefits including: job quality standards (living wage); local hiring programs; affordable housing; minority and local business contracting goals; union neutrality requirements; retail and commercial space set-asides for small and local businesses; green building requirements and other mitigation of adverse environmental impacts; space for child-care and community centers; construction of recreational facilities and parks; designated open space; and affordable housing requirements. Many of these benefits would not be obtainable if the local authorities were requesting them through exactions, as they would fail the substantial nexus to development impact tests expounded by the Supreme Court (discussed in more detail in the Legal and Policy Concerns section below).

ENFORCEABILITY

One purpose of a CBA is to ensure that the promises set forth by a developer regarding community benefits are legally enforceable. In return, the community coalition must also be held accountable for its promise to support (or not hinder) the development during the application period. Several issues exist related to the enforceability of CBAs:

CONTINUED ON PAGE 9

Survival of Environmental Indemnity Obligations in Loan Transactions—Are There Any Limits?

By Daniel W. Hardwick

Of all the documents included in a customary commercial real estate financing transaction, the environmental indemnity agreement (sometimes referred to as a "hazardous materials indemnity agreement") garners special attention given heightened concerns surrounding environmental issues. Lenders take an extremely conservative approach to possible exposure for environmental liabilities and have gone to great lengths to protect themselves. A typical environmental indemnity agreement requires both the borrower and guarantor (if applicable) of the loan to make representations and warranties related to the environmental condition of the property, as well as provide covenants not to bring hazardous materials to the property. The subject of this article, and the most important of the provisions of the environmental indemnity agreement, is the actual indemnity obligation of the indemnitor, wherein the lender is indemnified against all losses and damages incurred or suffered as a result of environmental issues at the property. Most lenders require that these indemnity obligations survive both repayment of the loan by the borrower and foreclosure by the lender. In some instances, an indemnitor is able to negotiate an expiration date to the indemnity either by providing a fixed period after repayment of the loan, or by delivering a clean environmental report upon repayment of the loan, but not all lenders will agree to such terms. Indemnity obligations with no fixed expiration date present a particular problem for sponsors or developers who enter into these agreements for multiple projects. Such obligations could constitute contingent liabilities that may need to be taken into account for financial statement footnote purposes and disclosed in other financing transactions. This article examines whether an agreement to extend an environmental indemnity obligation beyond either foreclosure or repayment of the loan is enforceable and, if so, whether there are any limits with respect to the duration of such obligations.

Most environmental indemnity agreements state that the indemnification obligation survives a foreclosure action by the lender or repayment of the loan by the borrower. Courts have consistently held that parties may contractually agree that an indemnification obligation can survive beyond foreclosure or repayment of the loan. Some lenders, however, are wary of relying on these court determinations, especially in "one action" or "security first" states such as California, wherein, generally, a lender must first exhaust all of its security as a condition of obtaining a money judgment against the borrower personally. So if the lender does not resort to all of its security before obtaining a money judgment on the underlying debt, the lender may be deemed to have made an "election of remedies" and to have waived the right to pursue the balance of its security. This in turn could include contractual rights under an environmental indemnity agreement. To protect themselves against this possibility, many lenders draft their environmental indemnity agreement so that it is explicitly not considered a "loan document" and not secured by the underlying real estate collateral. This is because the lender is concerned that the indemnity obligations would be extinguished in the event of a foreclosure or upon repayment of the loan, under the theory that if the indemnity obligations are outside the security for the loan, the obligations survive foreclosure even in a "one action rule" state. Typical language may read as follows:

> *Indemnitor agrees that this Environmental Indemnity Agreement is separate, independent of and in addition to its undertakings as Borrower pursuant to the Loan and the Loan Documents, including, without limitation, the Note and any other evidence of indebtedness or security executed in connection therewith. A separate action may be brought to enforce the provisions of this Environmental Indemnity Agreement, which shall in no way be deemed to be an action on the Note, whether or not the Loan has been repaid and/or whether or not Beneficiary would be entitled to a deficiency judgment following a judicial foreclosure or trustee's sale.*

Although courts have held that parties may contractually agree that an environmental indemnity can survive beyond a foreclosure or repayment of the loan, lenders in "one action states" frequently take additional precautions by using this type of provision to categorize the environmental indemnity as a separate, unsecured obligation of the borrower and guarantor.

But can indemnity obligations last indefinitely? According to some courts, they can. In 2008, the United States Eleventh Circuit Court of Appeals held "that an indemnity agreement with no explicit termination provision continues to remain in effect, notwithstanding the fact that the parties no longer

CONTINUED ON PAGE 10

Construction Loans: Lender Liability to Third Party Creditors

By Marc Anthony Angelone

When lenders become involved in management of the day-to-day operations of their borrowers, they also run the risk of becoming liable for the debts of those same borrowers through the instrumentality theory of lender liability. This so-called "instrumentality doctrine" is based upon agency principles and, to the extent that a court finds that a lender's control of its borrower is so pervasive that the borrower becomes a "mere instrumentality" of the lender, then courts have sometimes held lenders responsible for the borrower's debts to other creditors. The good news for lenders is that the instrumentality doctrine is a difficult one for third-party creditors to prove, especially in Massachusetts, where courts are not generally hospitable to the instrumentality doctrine. A recent Massachusetts Superior Court decision has made it even more difficult for a third-party creditor to successfully argue the theory in a construction loan scenario.

ELEMENTS OF INSTRUMENTALITY DOCTRINE

In order for a lender to be held liable for the debts of its borrower under the instrumentality doctrine, the following three factors are most often required:

- The lender actually controls the affairs of the borrower
- The lender uses its control to commit fraud or to bring about an unjust result
- The lender proximately causes harm to the plaintiff through misuse of its control

The general consensus among reported decisions is that a lender will not become liable for the debts of its borrower unless and until "it becomes so involved with the business of its borrower that it is actively managing the debtor's affairs." This is a hard test to meet and generally does not create lender liability until the lender's involvement is so pervasive that it has essentially assumed the "normal day-to-day business affairs of the borrower."

DISTINCTION BETWEEN CONTROL OF BORROWER AND CONTROL OF ASSET

In *Creative West Architects*, decided in June 2011, a construction lender took control of a real estate development project upon the default of the borrower. In a suit brought by another creditor against the construction lender, the Massachusetts Superior Court rejected the instrumentality doctrine by drawing a distinction between control of the borrower and control of the secured assets. The opinion stresses that the instrumentality theory is not applicable when a lender *exerts control over the secured assets, even when efforts to preserve the assets involve the lender in the daily management of the debtor's business*.

In *Creative West Architects*, the court recognized the pervasive day-to-day involvement of the lender in the construction project. The court acknowledged that the lender: (i) replaced the general contractor and many subcontractors and entered into its own contracts with them; (ii) participated in daily management decisions; (iii) made decisions without consulting the borrower; (iv) met on multiple occasions with an auctioneer for the purpose of marketing units; (v) paid on its own account for all up-front marketing costs; (vi) commented on, negotiated and signed a contract for auction services; (vii) assumed final decision-making authority on construction decisions; (viii) paid contractors and issued all construction payments directly; (ix) hired replacement architects; and (x) offered "inducements" to the borrower to participate in the auction. The court stated that, prior to the foreclosure sale, the borrower had "no further involvement in the [p]roject."

It is difficult to imagine a scenario in which the lender's control over a project would be more pervasive than it was in *Creative West Architects*. Not only did the lender take over the day-to-day business of construction, it also controlled unit sales to the detriment of the borrower. The lender extended closing dates until after the foreclosure took place and it had acquired ownership of the units. As the court noted "[i]t was in the borrower's interest to consummate those closings prior to foreclosure...because the outstanding loan obligations and potential deficiency of the borrower... would decrease considerably. The...auction absolutely had a negative effect on the value of the [p]roperty."

Although the lender in *Creative West Architects* took over complete control of the day-to-day management of the construction project, the court rejected the instrumentality doctrine: "The instrumentality theory addresses control over the borrower itself, not the project. The Bank here did nothing more than act to protect and realize its security, in which it had rights as a result of the mortgage transaction between it and [the Borrower]. It never 'assumed actual, participatory, total control' of [the Borrower] as opposed to the Project."

CONTINUED ON PAGE 11

STATE OF THE REAL ESTATE MARKET, *CONTINUED FROM PAGE 1*

advance money to fund tenant improvements and leasing commissions. So while we hear a lot of discussions about tenants leaving, invariably more tenants are staying put than in the past. And we see tenants more focused on efficiency, and generally taking less space than they would have in prior times.

- New development is difficult to justify in most markets, but there are exceptions, particularly where there are strong demand drivers. In Washington, there was the long held belief that the federal government (and its vendors) would always be able to absorb large blocks of space. In New York, there was the demand of Wall Street; in Boston, there were the hospitals and the universities. But the talk of spending cuts and reduced government is creating the fear that this time will be different. Rumors abound of major layoffs by financial service providers. All of which creates uncertainty, and raises the risk profile of new development.

- Everyone loves multifamily rental housing; but how long can the good times continue? As the percentage of homeownership in the country declines, the number of potential renters increases. Demographics are good, as Generation Y starts to enter the work force. Not only is demand positive, but there has not been much supply of new product for a several years. On the other hand, particularly in the prime markets, there is a lot of multifamily both under construction and on the drawing board, and if this all gets built then there are potential over-supply issues. And, pricing on multifamily sales at current cap rates reflect both plentiful debt availability at low rates, as well as a reasonable amount of rent growth.

- Affordable and mixed-use housing continues to be developed with use of many federal and state assistance programs. The FHA has been an active source for construction and permanent financing, and Fannie Mae and Freddie Mac, in addition to providing attractive permanent financing, have been able to provide credit enhancement for tax-exempt bond financed projects. Low Income Housing Tax Credits, New Market Tax Credits, and Historic Tax Credits all continue, and facilitate new and renovated projects in targeted areas. But participants in these programs are concerned that the strong support for these various programs could be materially impacted by proposed budget cuts and tax reform efforts under consideration.

- While all the typical real estate players still say they are in the market to acquire, demand seems to have peaked several months ago and pricing seemingly reflects that sluggishness. Pricing is still well above the lows of 2008/early 2009, but it just feels less robust than earlier in the year.

- When we considered the state of the real estate market two years ago, everyone was focused on workouts and distressed assets. We could all forecast that poorly underwritten loans, a collapse of the CMBS market, and a weak leasing market would lead to more work for lawyers in bankruptcy, foreclosures and workouts; and more opportunities for our clients to acquire distressed assets. But while there were of course many restructurings and workouts, the discounts and opportunity to generate the high returns of the early '90s did not appear, and those clients who geared up to participate in distressed assets were generally disappointed. We are not suggesting that everything was all hearts and flowers; there were still lots of workouts, foreclosures, bankruptcies and note sales (and attorneys still did fine), but rather the world of distressed assets could have been a lot worse.

- But it's not over 'til it's over, and there is still a lot of would be distress lurking, particularly with the number of poorly underwritten loans from 2006 to 2008 approaching maturity. So we wait to see what evolves in this area, particularly when "the can stops being kicked." One interesting observation has been the effectiveness of the bad boy guaranty—while not always perfect, the bad boy guaranty has generally been sustained by the courts, and (where a strong guarantor is involved) appears to have proven effective at reducing the number of actual bankruptcy filings. On the other hand, the sale of notes to "loan to own" purchasers seems on the assent, as the note purchaser has added confidence that it can get to the asset relatively quickly, where bankruptcy is not a viable option.

- Where is CMBS, and when is it coming back? We keep hearing that the new CMBS 2.0 is returning, and certainly the market needs it. It has been a slow and unsteady ride back, but it would greatly help the markets if CMBS were to become fully functional again. Banks and life companies have been plentiful lenders for the prime, properly structured projects in good markets (coincidentally, where most of our partners practice); but even adding in the GSEs, there is simply not enough lending capacity without the capital markets.

CONTINUED ON PAGE 10

RETAIL LEASES IN BANKRUPTCY, *CONTINUED FROM PAGE 2*

If a debtor involved in bankruptcy proceedings fails to perform lease obligations that remain enforceable after the Petition Date, the landlord must seek the approval of the Bankruptcy Court before taking action against the debtor. Unpaid rent and other lease charges incurred after a bankruptcy filing are administrative expenses of the estate and are entitled to priority over all unsecured claims.

ASSUMPTION AND REJECTION

Prior to the enactment of bankruptcy reform legislation in 2005, debtors were often able to obtain indefinite extensions of time during which they could decide whether to assume or reject their leases. Now, however, under the provisions of the Bankruptcy Code as amended in 2005, the debtor must assume or reject a lease of commercial property by the earlier of (a) the date that is 120 days after the date of a voluntary filing or the date that an involuntary proceeding is found to be proper, or (b) the date of entry of an order confirming a reorganization plan. On motion of the debtor or the landlord, the court may grant a 90-day extension. If the court grants the 90-day extension, it may not grant subsequent extensions without the prior written consent of the landlord. This new condition is a key aspect of the 2005 legislation that has made reorganization more difficult for retailers with a large number of leased locations.

In order to assume or reject a lease, the debtor must seek approval from the court. Generally, if the debtor's decision to assume appears to be in the best interest of creditors, the court will approve the decision. Courts apply a business judgment test—whether the decision to assume or reject is based on sound business judgment or is manifestly unreasonable. As a general rule, the effect of rejection on the individual landlord is not considered. Leases may not be assumed in part and rejected in part, but must be assumed or rejected as a whole, subject to the power of the court to invalidate certain provisions, as described below.

Where there has been a default in an unexpired lease of commercial property, the debtor may not assume the lease unless the debtor (1) cures the default or provides adequate assurance that the default will be cured; (2) compensates the other party to the lease for any pecuniary loss, or provides adequate assurance of compensation; and (3) provides adequate assurance of future performance. This means that the debtor must pay all past due rent, tax and operating expense payments and other sums due under the lease and may also require payment of the landlord's attorneys' fees. Note, however, that the debtor is not required to cure any defaults under "*ipso facto*" clauses. Providing "adequate assurance" in lieu of immediate payment usually means making payments over time with interest. Providing adequate assurance of future performance usually involves security deposits or guarantees, and is also discussed below in connection with assignments.

A lease of commercial property is deemed rejected if it is not assumed within the limited time period described above. Rejection of a lease is deemed a breach of the lease, and this entitles the landlord to damages. The landlord's claim is generally treated as unsecured unless the landlord holds a security deposit or other security. The amount of the landlord's claim is made up of two parts—amounts owing and unpaid as of the Petition Date and future rent due for periods after the effective date of rejection. The amount due for periods prior to filing is not subject to any limit, but the claim for future rent is subject to a cap which is the greater of (1) the rent reserved in the lease, without acceleration, for the one-year period beginning on the Petition Date, or (2) 15 percent of the rent reserved for the remaining term of the lease, without acceleration, not to exceed three years' rent.

ASSIGNMENT

When the debtor assumes a lease, it often wants to assign it to a third party in order to raise funds for distribution to creditors or to fund a plan of reorganization. While under current economic conditions, below market leases may be hard to find, in better times unexpired leases are often quite valuable. Most leases contain provisions prohibiting or sharply limiting the tenant's right to assign its interest under the lease without the consent of the landlord. What is the effect of these provisions in bankruptcy or reorganization proceedings? The Bankruptcy Code provides that lease terms prohibiting, restricting or conditioning the assignment of the lease are not enforceable. The strong policy considerations in favor of the debtor's ability to dispose of its property have led courts to go even further, and courts have sometimes invalidated use clauses, provisions permitting the landlord to share in subleasing or assignment profits, and similar lease terms that have the effect of restricting or limiting the debtor's ability to dispose of its leases. Note, however, the more restrictive rules applicable to shopping center leases, discussed in the following section of this article.

CONTINUED ON PAGE 8

RETAIL LEASES IN BANKRUPTCY , *CONTINUED FROM PAGE 7*

The debtor may assign the lease only if the assignee provides “adequate assurance of future performance,” including the special rules applicable to shopping center leases. This requirement usually involves an analysis of the assignee’s financial condition and ability to satisfy the tenant’s obligations under the lease. Courts will also consider factors such as guarantees and security deposits. Once the lease has been assigned, the debtor no longer has any obligation under the lease, notwithstanding any lease terms or provisions of applicable state law to the contrary.

SHOPPING CENTER LEASES

If the lease involves space in a “shopping center” there are special rules concerning satisfaction of the requirements of adequate assurance of future performance for purposes of lease assignment and curing existing defaults. These rules are designed to protect the shopping center landlord’s interest in maintaining the tenant mix of the center, which is usually accomplished through lease provisions restricting use of the leased premises, radius restrictions, exclusivity clauses and similar terms.

The Bankruptcy Code does not contain a definition of “shopping center,” but the term is likely to be strictly construed. Considerations found to be significant have included multiple retail leases of contiguous premises from a single landlord, common parking, and the existence of common area charges and common rules of operation applicable to all retail tenants.

Among other factors, the proponent of an assumption of a shopping center lease in default or an assignment of the lease must provide adequate assurance:

i. of the source of rent payment and, in the case of an assignment, the financial condition of the new tenant being no worse than that of the debtor as of the time the debtor became the tenant

ii. that any percentage of rent due under the lease will not decline substantially

iii. that the assumption or assignment is subject to all of the provisions of the lease, including those concerning radius, location, use or exclusivity, and will not breach any such provision contained in any other lease, financing agreement or master agreement relating to such shopping center

iv. that the assumption or assignment will not disrupt any tenant mix or balance in such shopping center

Notwithstanding these very specific protections provided to shopping center landlords, prior to the 2005 amendments to the Bankruptcy Code some courts ruled that where compliance with a use clause is impossible, or where the use clause is the functional equivalent of an anti- assignment clause, the use clause should not be enforced. The 2005 amendments made clear that the provisions of the Bankruptcy Code overriding anti-assignment clauses are subject to the specific protections given to shopping center leases. Nevertheless, the legislative history of some of the applicable sections of the Code may still provide support for the conclusion that use clauses requiring the tenant to operate under a specific trade name are not enforceable.

SUMMARY

Current economic conditions have been very difficult for retailers, and many of them have sought relief from the bankruptcy courts. Commercial landlords need to be prepared to understand the effect that tenant bankruptcy and reorganization proceedings will have on their leases and to deal with the results. <

COMMUNITY BENEFIT AGREEMENTS , *CONTINUED FROM PAGE 3*

Against Whom Is a CBA Enforceable?

When negotiating the CBA, it is important to consider which parties will have standing to enforce the agreement. Signatories to a contract have standing and, in certain cases, third-party beneficiaries may have standing, if certain requirements, including an intention to confer a benefit, are satisfied. Several issues arise when the coalition as a legal entity enters into a CBA. Often, coalitions that sign these agreements are not incorporated or formally organized entities. If the coalition is not an incorporated nonprofit entity, it probably has the legal status of an unincorporated association. Various complications arise from this status and it is thus advisable for each member group or organization to sign the CBA on its own behalf to ensure that each organization has the legal standing to enforce the CBA. Following this approach also assures the developer that it can enforce the CBA against each organization. Additionally, depending on the requirements laid out in the CBA related to hiring and procurement, the CBA may need to identify certain requirements that are enforceable against the developer's subcontractors and tenants. This will require the subcontractors and tenants acknowledgement that they are so bound — either by joining them as parties to the CBA or incorporating the relevant provisions in stand-alone agreements.

Careful Drafting

As with all contracts, precise and thorough drafting is crucial. Particular areas of concern include monitoring compliance, deadlines for each promise and careful consideration of remedies. Administratively, it is a challenge for community groups to keep track of benefits such as living-wage and hiring requirements. Monitoring costs and responsibilities should be clearly delineated in the CBA. CBAs are also prone to aspirational or illusory language that embodies intentions but not clearly enforceable promises. These types of provisions are often phrased in terms such as the developer "intending" or "working towards" specific goals and are likely unenforceable.

LEGAL AND POLICY CONCERNS

The process of negotiated development has evolved over the years along with land use and zoning regulations. To simplify, over the years zoning has progressed from a set of rigid rules to more flexible standards that allow more individualization and that address impacts of projects and concerns raised by affected neighborhoods. The judicial system has weighed in particularly in the context of exactions and impact fees. The concept behind exactions is that developers, rather than communities and taxpayers, should bear the costs and risks of development and should be obligated to mitigate the undesirable consequences of development. Courts were initially wary of exactions due to the scope of authority exercised by local governments. In two pivotal decisions, the Supreme Court created the so-called "Nollan-Dolan Standard": (1) a nexus requirement providing that the benefit the government seeks to exact from a developer must have an essential nexus to a legitimate state interest and (2) a proportionality requirement stating that the amount of the benefit the government seeks has to be roughly proportional to the impact that particular development would impose.[1]

It should be noted that the *Nollan* and *Dolan* cases apply specifically to local governments, not to agreements between private parties. Therefore, arguably, CBAs can go beyond what would survive scrutiny under the Nollan-Dolan Standard that applies to government exactions — meaning community groups may be able to secure concessions that are "unrelated" to a development's land use impacts. Although the Nollan-Dolan Standard does not directly apply to CBAs negotiated exclusively between private parties (the developer and the community coalition), the concepts may still be applicable and at a minimum highlight some of the potential dangers and risks associated with CBAs.

Moreover, there is an argument that a community coalition's bargaining power stems from an informal requirement that a developer enter into a CBA before it can seek governmental approval of the land use proposal. If this is the case, the requirement, even if implicit, may be viewed as posing a risk of extortion as depicted in the *Nollan* and *Dolan* cases. In certain instances, CBAs are negotiated partially in response to encouragement from local officials and they are sometimes incorporated into a development agreement between the developer and local government. It is an open question whether this arrangement would survive judicial scrutiny related to the constitutional limitations on government exactions. State and local governments need to address these concerns, possibly through legislation. While CBAs may be an appropriate vehicle for community coalitions to impose requirements for economic subsidies, local governments should be cautious when considering CBAs in the land use approval process unless they meet the Nollan-Dolan Standard.

CONTINUED ON PAGE 10

1 *Nollan v. California Coastal Commission*, 483 US 825 (1987) and *Dolan v. City of Tigard*, 512 US 374 (1994).

SURVIVAL OF ENVIRONMENTAL INDEMNITY OBLIGATIONS,
CONTINUED FROM PAGE 4

have any other contractual relationship." The court went on to state that "it is very common for an indemnity provision not to include an expiration date" and "if the parties desired to provide a termination date, they would have unambiguously done so."

When a contract has an indefinite term, courts often supply a "reasonable" time for a party's performance under the contract. It has been suggested that this principle might be applied to environmental indemnity agreements. However, an environmental indemnity agreement typically does not require performance by a party until a cause of action has accrued, and courts have held, for indemnity agreements generally, that the cause of action does not accrue until the indemnified party is required to pay. It is impossible to impose a "reasonable" time for performance before performance is actually required. In addition, a court is unlikely to cut short an indefinite term when sophisticated parties have agreed to such a provision as part of a commercial loan transaction.

It should be noted that although indemnity obligations can have an indefinite term, parties should consider whether any statute of limitations applies. A statute of limitations sets out a maximum time period during which certain actions can be brought or rights enforced. For contractual indemnity obligations, however, the timeframe under the statute of limitations starts when the indemnified party (i.e., the lender) actually has paid an indemnity claim (i.e., a claim has accrued) and not when the indemnity agreement is executed. Environmental indemnity agreements sometimes contain an agreement by the indemnitor to waive the statute of limitations. An indemnitor's agreement to waive or extend the statute of limitations made at the time the agreement is executed is invalid under legislation or judicial decisions in many states.

It should be noted that the federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), which imposes strict, joint and several liability for owners or operators of commercial real estate, provides environmental liability protection for "qualified" lenders who can be exempt from the definition of "owner or operator" if the lender does not "participate in the management" of the real estate and only holds its interest in the real estate to protect its rights as holder of the mortgage or deed of trust. Similar legislation exists in many states. In the case of a lender's loss caused by a lender's own actions, statutory and common law principles in many states may render indemnity agreements unenforceable. This is because, as a matter of public policy, a party should not be indemnified against its own negligence or wrongdoing. Therefore, despite the risk that environmental indemnity agreements could have virtually unlimited life spans, CERCLA and other statutory and common law principles should reduce the risk to borrowers, sponsors and developers who sign customary environmental indemnity agreements with indefinite terms. <

STATE OF THE REAL ESTATE MARKET, *CONTINUED FROM PAGE 6*

- And lastly, there is great disparity in how one views the real estate market based on the area of your expertise. Are you a first lender or mezz? Buyer of distressed assets, or owner of the distressed asset? Are you a core investor or opportunistic? Are you in the prime markets or tertiary? Downtown or suburbs? Hotels; retail; industrial; office? Is now the time to sell or to buy? Or is it time to go fishing.

In any event, we look forward to helping you with your legal concerns in the months ahead. <

COMMUNITY BENEFIT AGREEMENTS , *CONTINUED FROM PAGE 9*

In part because of their relative newness, CBAs have a somewhat murky legal status. Legal and policy issues surrounding the use of CBAs will continue to evolve and it is likely that legislatures and courts will eventually address what the appropriate role is for CBAs in the development and land use process. Until that time, developers and communities alike should be cognizant of the risks as well as the rewards associated with CBAs so they can make educated decisions as they negotiate mutually beneficial developments. <

CONSTRUCTION LOANS, *CONTINUED FROM PAGE 5*

One of the justifications this court and others have used to support narrowing the scope of the instrumentality doctrine and, therefore, lender liability, is public policy favoring a lender-friendly marketplace. The argument is that if courts too easily find lenders liable for the debts of their borrowers, it will have a negative effect on lending. In *Creative West Architects*, the court expressly noted that, "[t]o impose liability on facts like those present here would impair the value of collateral and chill the extension of credit for housing projects."

SIMILAR ARGUMENTS POSSIBLE IN EQUITABLE SUBORDINATION CONTEXT

Although *Creative West Architects* is a Massachusetts Superior Court decision, it will be interesting to see if the same arguments and reasoning applied by that court to limit construction lender liability will be followed in other lender agency contexts, such as claims based on the theory of equitable subordination. The theory of equitable subordination arises in the bankruptcy context, where a lender, through its pervasive control of its borrower, takes actions that cause inequitable beneficial results for itself at the expense of other creditors. In that situation, bankruptcy courts have applied equitable subordination to cause the lender's claims against the debtor to be subordinated to the claims of other creditors.

The elements of equitable subordination are similar to those of the instrumentality doctrine and also require that the lender be involved in the day-to-day operations of the borrower. The creditors must prove:

- The lender has engaged in inequitable conduct
- Other creditors have sustained injury from the conduct, or the lender has gained an unfair advantage from it
- Equitable subordination of the lender's claim would not be inconsistent with the Bankruptcy Code

In the bankruptcy context, where bankruptcy courts can exercise equitable remedies, it will be interesting to see if the distinction between control of the borrower and control of the secured assets, as made in the *Creative West Architects* case, will also be used by construction lenders' counsel to fend off equitable subordination claims.

CONCLUSION

While successfully arguing for construction lender liability to third-party creditors is already a difficult task, the reasoning used by the court in *Creative West Architects* will make it even more difficult. It remains to be seen whether the decision will be affirmed on appeal and followed by other courts. <

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