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REAL ESTATE

FOUNDATION

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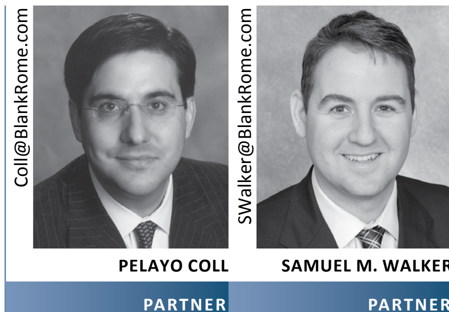
A Note from the Chairs

BY PELAYO COLL AND SAMUEL M. WALKER



Welcome to the April edition of *Foundation,* Blank Rome's quarterly real estate newsletter. This issue contains timely articles on recent developments affecting the real estate world as well as updates on what has kept us busy since the start of the new year.

Blank Rome's real estate group and the real estate market in general continues to prosper in 2016. We had an extremely busy first quarter and closed some of the biggest transactions that we have closed in years, including the Inland transaction noted in our "Noteworthy Real Estate Deals" (page 12). We are so thankful for our clients and their support, and look forward to continuing to help them grow and prosper.

We are also excited that Blank Rome LLP added more than 100 attorneys from Dickstein Shapiro in our New York and D.C. offices (including four lawyers that joined our real estate group in D.C.). The addition of these talented lawyers has significantly broadened and deepened our ability to provide legal services to our clients.

We hope you enjoy this edition of our newsletter, and please feel free to reach out to us with any comments.

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FinCEN's Latest Geographic Targeting Orders Tackle Secrecy in Luxury Real Estate Transactions

BY MATTHEW D. LEE AND JED M. SILVERSMITH

In yet another sign of its aggressive campaign to fight money laundering, the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") has trained its sights on the high-end real estate market in New York and Miami. With the issuance of a little-known yet incredibly powerful anti-money laundering tool called a "Geographic Targeting Order" ("GTO"), FinCEN now requires title insurance companies to identify the natural persons behind companies used to pay all cash for luxury residential real properties located in the Borough of Manhattan and Miami-Dade County.[1] According to a press release announcing the issuance of the GTOs, FinCEN is concerned that individuals are using all-cash purchases of real estate as a mechanism to carry out money laundering, and such individuals are using limited liability companies or other opaque structures to conceal their identities in such transactions.[2] Under the terms of these GTOs, any title insurance company involved in an all-cash real estate transaction with a purchase price exceeding three million dollars in Manhattan, or exceeding one million dollars in Miami-Dade County, must report such a transaction to FinCEN and, in particular, identify the "beneficial owner" of the entity used to facilitate the purchase.

Background Regarding Geographic Targeting Orders

A GTO is an administrative order issued by the director of FinCEN requiring all domestic financial institutions or nonfinancial trades or businesses that exist within a geographic area to report on transactions any greater than a specified value. GTOs are authorized by the Bank Secrecy Act ("BSA"). Originally, GTOs were only permitted by law to last for 60 days, but that limitation was extended by the USA Patriot Act to 180 days. GTOs are typically not made public, and generally only those businesses served with a copy of a particular GTO are aware of its existence.

Over the course of the last 24 months, FinCEN—the primary agency of the U.S. government focused on anti-money laundering compliance and enforcement—has exercised its authority to issue GTOs frequently throughout the United States in areas where money laundering is believed to be widespread. Recent GTOs have focused on shipments of cash across the border in California and Texas; the Fashion District of Los Angeles; exporters of electronics in South Florida; and check cashing businesses in South Florida. In each of these instances, FinCEN publicly announced the issuance of the GTO and its terms, and expressed concern that the industries or regions in question were highly susceptible to money laundering.

Prior Efforts to Prevent Money Laundering in Real Estate Transactions

For several years, FinCEN has sought to ensure financial transparency and combat illegality in the real estate market. In February 2015, *The New York Times* published a series of articles focused on the use of shell companies to purchase high-value real estate in New York City.[3] In a

November 2015 speech, FinCEN's director disclosed that through analysis of BSA reporting and other information, FinCEN has observed the frequent use of shell companies by international corrupt politicians, drug traffickers, and other criminals to purchase luxury residential real estate in

(continued on page 3)

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FinCEN's Latest Geographic Targeting Orders Tackle Secrecy in Luxury Real Estate Transactions (continued from page 2)

cash. FinCEN has uncovered funds transfers in the form of wire transfers originating from banks in offshore havens at which accounts have been established in the name of the shell companies. The perpetrator will direct an individual involved in the settlement and the closing in the United States to put the deed to the property in the name of the shell company, thereby obscuring the identity of the owner of the property.

The BSA established anti-money laundering obligations for financial institutions, including institutions involved in real estate transactions. By including these businesses in the definition of "financial institution," Congress recognized the potential money laundering and financial crime risks in the real estate industry. In the USA PATRIOT Act, Congress mandated that FinCEN issue regulations requiring financial institutions to adopt Anti-Money Laundering ("AML") programs with minimum requirements, or establish exemptions, as appropriate. Since that time, FinCEN has implemented AML requirements for certain real estate businesses or established exemptions for others consistent with the BSA.

Over the course of the last 24 months, FinCEN—the primary agency of the U.S. government focused on anti-money laundering compliance and enforcement—has exercised its authority to issue GTOs frequently throughout the United States in areas where money laundering is believed to be widespread.

One particular area of recent focus for FinCEN is seeking greater transparency in the area of beneficial ownership of corporate entities. To that end, in July 2014, FinCEN issued proposed regulations that would amend existing BSA regulations to help prevent the use of shell and shelf companies to engage in or launder the proceeds of illegal activity in the U.S. financial sector. As proposed, the regulations would clarify and strengthen customer due diligence obligations of banks and other financial institutions, including brokers or dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities. The proposed amendments would add a new requirement that these entities know and verify the identities of the real people who own, control, and profit from the companies they service.

In the press release announcing the issuance of the two GTOs focused on real estate transactions, FinCEN Director Jennifer Shasky Calvery said that her agency was "seeking to understand the risk that corrupt foreign officials, or transnational criminals, may be using premium U.S. real estate to secretly invest millions in dirty money." Director Calvery further explained that "[o]ver the years, our rules have evolved to make the standard mortgage market more transparent and less hospitable to fraud and money laundering. But cash purchases present a more complex gap that we seek to address. These GTOs will produce valuable data that will assist law enforcement and inform our broader efforts to combat money laundering in the real estate sector." Information gathered by title insurance companies and reported to FinCEN will be utilized by federal law enforcement agencies to enhance their ability to identify the natural persons involved in transactions vulnerable to abuse for money laundering, and will combat the ability of individuals to disguise their involvement in such transactions.

Terms of the Manhattan and Miami-Dade GTOs

The latest GTOs focused on real estate transactions apply to title insurance companies engaging in "covered transactions," which are defined as transactions in which (1) a legal entity (2) purchases residential real estate either in the Borough of Manhattan or Miami-Dade County (3) for a total purchase price in excess of three million dollars (Manhattan) or one million dollars (Miami-Dade) (4) without a bank loan or other similar form of external financing, and (5) using, at least in part, currency or a cashier's check, certified check, traveler's check, or money order. "Legal entity" is defined as a corporation, limited liability company, partnership, or other similar business entity, whether domestic or foreign.

If a title insurance company is engaged in a transaction that meets all of the requirements for a "covered transaction," the title insurance company must report said transaction to FinCEN within 30 days of the closing using a designated form entitled "FinCEN Form 8300." On the Form 8300, the title insurance company must identify (1) the purchaser; (2) the purchaser's representative, if any; and (3) the beneficial owner, which is defined as each natural person who, directly or indirectly, owns 25 percent or more of the equity interests of the purchaser. The title insurance company

must obtain and copy the driver's license, passport, or other similar identification for each beneficial owner. The title insurance company must retain all records relating to the GTO for at least five years and make such records available to FinCEN or any other law enforcement or regulatory agency upon request.

The Manhattan and Miami-Dade GTOs went into effect on March 1, 2016, and will remain effective until August 27, 2016, unless extended by subsequent order of the FinCEN director. Each title insurer subject to the GTO is required to supervise, and is responsible for, compliance by each of its officers, directors, employees, and agents. The title insurance company must transmit a copy of the GTO to each of its agents, and must also transmit a copy to its chief executive officer or similarly acting manager. Any title insurance company, and any of its officers, directors, employees, and agents, may be held liable for civil or criminal penalties for violating any terms of the GTO.

Implications of FinCEN's Latest GTOs

Title insurance companies handling transactions occurring in Manhattan or Miami-Dade County are required to be familiar with the obligations imposed by these latest GTOs. Title insurance companies would be well-advised to implement training programs so that they are prepared to address these new compliance obligations, which took effect March 1, 2016.

Companies that fail to comply with the reporting and recordkeeping requirements of these GTOs may face civil or criminal penalties. While the terms of each GTO currently last for only six months, FinCEN will likely extend the duration of each GTO for an additional six months, and may even make them permanent through further regulatory action. Finally, depending upon the quality of the information reported to FinCEN by title companies in Manhattan and Miami, FinCEN may well determine to expand the geographic reach of these orders to other parts of the United States. ◻ —©2016 BLANK ROME LLP

This article was first published in the January 22, 2016, edition of *Law360.* Reprinted with permission.

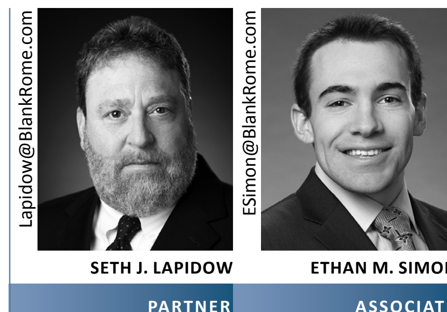
1. The Manhattan GTO is available here: https://www.fincen.gov/news_room/nr/files/Real_Estate_GTO-NYC.pdf. The Miami-Dade GTO is available here: https://www.fincen.gov/news_room/nr/files/Real_Estate_GTO-MIA.pdf.

2. FinCEN's press release dated January 13, 2016, is available here: https://www.fincen.gov/news_room/nr/html/20160113.html.

3. *See* "Towers of Secrecy," *The New York Times,* February 8-12, 2015 (available at http://www.nytimes.com/2015/02/08/nyregion/the-hidden-money-buying-up-new-york-real-estate.html?_r=0).

Third Circuit Refuses to Recognize Duty to Warn Homebuyer about Volatile Neighbor

BY SETH J. LAPIDOW, ETHAN M. SIMON, AND MARCIE GETELMAN*



Developers in New Jersey can breathe a sigh of relief as the Third Circuit Court of Appeals affirms the New Jersey District Court in holding that a property developer has "no duty to disclose off-site social conditions, such as the personality traits of a neighbor" to potential homebuyers. *Phoenix v. U.S. Homes Corp.,*--- F. App'x---, No. 14-4463, 2015 WL 6152896, at *2 (3d Cir. Oct. 20, 2015). The Court of Appeals agreed that New Jersey law does not permit the expansion of the duties of home sellers to include informing buyers of potential social problems with other residents, and reinforced the New Jersey Rule that sellers are only obligated to disclose offsite conditions of the land that are unknown to the buyer and unobservable. The chaos that would have ensued from a finding of a duty to disclose the personal characteristics of homeowners to prospective purchasers is hard to imagine.

Background

The plaintiff, Cydnee Phoenix ("Phoenix"), alleged that she visited Cedar Point, a residential community developed by Defendant Lennar Homes ("Lennar"), looking to purchase a home. A Lennar sales representative showed Phoenix a home that she would eventually purchase the following month.

Phoenix claimed that during her visit, Kevin Potter ("Potter"), who resided across the street from the subject property, approached Phoenix and warned her about dealing with Lennar and directed an angry tirade at the Lennar representative. Phoenix claimed to have asked the sales representative if there was a problem with Potter and alleged that the sales representative replied that there was "no problem."

(continued on page 5)

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Third Circuit Refuses to Recognize Duty to Warn Homebuyer about Volatile Neighbor (continued from page 4)

After moving into her new home, Potter began to park his vehicles in front of Phoenix's home in a way that made it hard for her to get to her mailbox, directed hostile comments to her family members, made racist comments about them, spit in their direction, played loud music, called the police on Phoenix, and stared down and took pictures of Phoenix's guests. Phoenix complained to the local authorities and obtained a restraining order against Potter and, for a time, hired a security guard.

The Court of Appeals agreed that New Jersey law does not permit the expansion of the duties of home sellers to include informing buyers of potential social problems with other residents, and reinforced the New Jersey Rule that sellers are only obligated to disclose offsite conditions of the land that are unknown to the buyer and unobservable.

Phoenix claimed that she later learned that Lennar and Potter had a dispute about his level of services and that Potter had angry interactions with Lennar's employees prior to Phoenix's purchase.

Lawsuit and Legal Implications

In her lawsuit, Phoenix alleged that Lennar knew of Potter's hostile tendencies and did not inform Phoenix about them prior to the sale. According to Phoenix, she would not have purchased the property had she known about Potter's behavior, and she relied on Lennar's agent's statement that Potter was not a problem and the statements in promotional materials that the community promised a "wonderful lifestyle." Phoenix brought claims against Lennar for fraud, equitable fraud, negligent misrepresentation and omission, violation of the New Jersey Consumer Fraud Act ("CFA"), violation of the Planned Real Estate Development Full Disclosure Act ("PREDFDA"), and negligent infliction of emotional distress. Applying New Jersey law, the district court dismissed the entire complaint. *Phoenix v. U.S. Homes Corp.,* 2014 WL 5667555 (D.N.J. Nov. 3, 2014).

Phoenix attempted to expand the scope of a developer's duty to disclose conditions in a development by alleging that Lennar had a duty to reveal all the information it had about Potter once Phoenix inquired about him. Phoenix argued that the statement "no problem" triggered a duty because she had articulated a "specific need." But the trial court found that the statement was not a "fact" but "nothing more than an 'ill-defined opinion.'" *See Perri v. Prestegious Homes, Inc.,* 2012 WL 95564 (N.J. Super. Ct. App. Div. Jan. 13, 2012). The lack of a misrepresentation of material fact doomed any claim under the common law, the New Jersey Consumer Fraud Act, and PREDFDA. In addition, the trial court found that the terms of Lennar's Sales Agreement precluded Phoenix's claims of fraud because it "disclaims any reliance on statements outside of the contract." *See Donachy v. Playground Destination Props., Inc.,* 2013 WL 3793033 (D.N.J. July 19, 2013) ("[I]t is manifestly unreasonable for a party to rely on prior oral statements when express language of the contract is written explicitly disclaiming any reliance on a previous communication."); *Pathfinder Mgmt. Inc. v. Mayne Pharma,* 2008 WL 3192563 (D.N.J. Aug. 5, 2008). Phoenix's claims, although presented in a novel factual setting, fell short when measured against well-settled New Jersey principles.

On appeal, the Third Circuit affirmed the district court's findings that while the complaint "paints an unpleasant and unenviable experience," New Jersey provides for redress by an action against Potter, but not the developer. The court explained that while developers have a "duty to disclose off-site conditions that are material to the transaction, [they] [have] no 'duty to investigate or disclose transient social conditions in the community that arguably affect the value of the property.'" 2015 WL 6152896, at *2 (quoting *Strawn v. Canuso,* 657 A.2d 420, 431 (N.J. 1995), *superseded on other grounds by* N.J.S.A. § 46:3C-10). The court also affirmed that under *Strawn,* 140 N.J. at 65, the only duty a developer in New Jersey has is to disclose "off-site physical conditions know to [them] and unknown and not readily observable by the buyer," and that under *Levine v. The Kramer Group,* 354 N.J. Super. 397, 405 (App. Div. 2002), a disgruntled neighbor is not a physical condition but "a social condition which the…defendants were under no duty to disclose." The court also affirmed the finding that the alleged statement about Potter was not an actionable fact, but merely an "idle comment conveying [an] opinion about Potter" and that the advertised statements of a "wonderful lifestyle" were "puffery and not actionable misrepresentations of fact." Thus, the Third Circuit affirmed the district court's findings that this novel claim was properly dismissed under well-settled New Jersey legal principles.

A Cautionary Disclosure Tale

Of course, a ruling to the contrary would create havoc for developers and would be in tension with other rules because sellers are forbidden by various laws to disclose information about other homeowners and a "social condition" disclosure requirement could run afoul of those rules. For example, New Jersey law dictates that a New Jersey real estate licensee cannot advise a home buyer that there are neighbors that are subject to Megan's Law notification requirements for convicted sex offenders. A home buyer must obtain that information by his own investigation. Similarly, the Federal Fair Housing Act and its regulations prohibit a seller from "communicating to any prospective purchaser that he or she would not be comfortable or compatible with existing residents of a community, neighborhood or development because of race, color, religion, sex, handicap, familial status, or national origin." 24 C.F.R. 100.7(c)(3). Developers would face an impossible task if required to determine what characteristics of homeowners would require disclosure, and would impose upon any home seller a duty to disclose not just protected characteristics, such as race, religion, and familial status, but also the personality traits and unique characteristics of each and every surrounding neighbor. Would a home seller have an obligation to disclose that the neighbor's children wake up at 6:00 a.m. every weekend and play basketball outside their bedroom window or, indeed, that a neighbor is litigious and brought suit against other neighbors to remove overgrown trees and other encroachments on their property? Indeed, would Lennar have had to disclose to other potential buyers that Phoenix herself was litigious?

Developers should not simply rely on the affirmation of this New Jersey rule, but they are encouraged to follow Lennar's example and draft their sales agreements to cut off these kinds of *post hoc* claims of detrimental reliance. Lennar's sales agreement, in addition to an integration clause, specifically required the buyer to set forth any "statements, representations or understandings which are made by a sales person or any other representative of Seller which are material to Buyer's decision to purchase. Buyer should insist that any such statement, representation or understanding is put in writing and contained in the Agreement…" Further, the sales agreement provided that "the sole inducement to close on the purchase of the property is the property itself." Phoenix did not list the alleged representation made about Potter as something upon which she relied in making her purchase and, thus, failed to provide the court with a sound factual basis on which to sustain her claims beyond the pleadings stage.

Conclusion

These contractual terms thus played a critical role and reinforced the legal conclusion that there was no duty to disclose. The district court considered these terms even though the plaintiff failed to include them because the plaintiff expressly referred to the Sales Agreement in her complaint. *See Adamson v. Ortho-McNeil Pharm., Inc.,* 463 F. Supp. 2d 496, 500 (D.N.J. 2006) ("The failure of a plaintiff to attach or cite documents in the complaint does not preclude a court from reviewing the text of extrinsic documents); *N.J. Best Phone Cards Corp. v. Nobeltel, LLC,* 2013 U.S. Dist. LEXIS 157499, at *7 (D.N.J. Nov. 4, 2013) (citing *Sentinel Trust Co. v. Universal Bonding Ins. Co.,* 316 F.3d 213, 216 (3d Cir. 2003) ("In evaluating a motion to dismiss, the court may consider the allegations of the complaint along with documents attached to or specifically referenced in the complaint."). The court's dismissal of Phoenix's suit shows the effectiveness of this contractual language in cutting off consumer reliance. ◻ —©2016 BLANK ROME LLP

**Seth Lapidow, Jonathan Korn, and Ethan Simon of Blank Rome LLP represented Lennar before both the District Court and the Third Circuit, along with Marcie Getelman, the Deputy General Counsel of Lennar.*

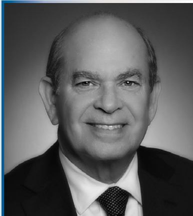
This article was first published in the March 4, 2016, edition of the *New Jersey Law Journal.* Reprinted with permission.

Blank Rome Points of Interest

New Hires & Elevations

- **Blank Rome welcomed more than 100 attorneys and additional staff from Dickstein Shapiro LLP's** New York and Washington, D.C., offices to the Firm. As a result of this deal, Blank Rome offers its combined client base expanded and enhanced capabilities. The Firm now has more than 600 attorneys across 14 offices; a more robust presence in Washington, D.C., that is more than triple its prior size and includes prominent insurance coverage and government contracts practices; an expanded, leading intellectual property group, both in terms of size and experience; and greater strategic depth in other core areas, including corporate and finance, real estate, and litigation. Please click here to learn more.

- Blank Rome welcomed **Michael C. Cohen**, former partner at Morrison & Foerster, to the Firm's Los Angeles office as a partner in the corporate, M&A, and securities group. Real estate is a significant area of practice for Mr. Cohen, including substantial experience in a variety of transactions such as complex acquisition and disposition transactions; real estate development partnerships and joint ventures; construction projects; leasing arrangements; and sale-leaseback transactions. Please click here to learn more.


MICHAEL CARL COHEN

- **Carol A. Gershon** was elected partner, and **James K. Freeman** was elevated to of counsel, in the Firm's real estate group. Please click here to learn more.

CAROL A. GERSHON

JAMES K. FREEMAN

- Blank Rome welcomed **Caitlin Sanders** to the Firm's Los Angeles office as an associate in the labor and employment group, where she will collaborate extensively with the Firm's real estate group on a wide range of real estate and business matters. Please click here to learn more.

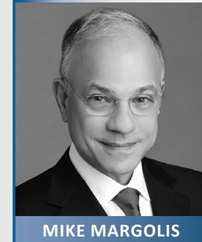
CAITLIN I. SANDERS

Media

SAMUEL M. WALKER

HENRI CHALOUH

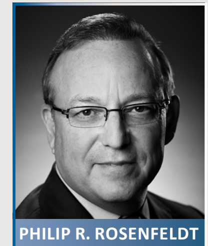
- Blank Rome partner **Samuel M. Walker**, who co-chairs the Firm's real estate group, and associate **Henri Chalouh** are noted as representing Equinox in the following *New York Law Journal* article, Marketplace: Developer to Turn NYSE-Adjacent Building Into Luxury Apartments, published on January 20, 2016.


MIKE MARGOLIS

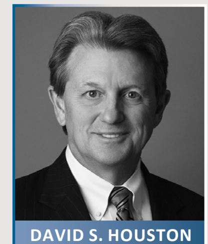
- Blank Rome Partner **Mike Margolis** authored the article, China's Fall? Do Homefront Woes Signal the End to U.S. Investment?, in the January/February 2016 edition of *Commercial Investment Real Estate.*

Speaking Engagements

PELAYO COLL


PHILIP R. ROSENFELDT

- Blank Rome Partners **Pelayo Coll** and **Phil Rosenfeldt** presented at the Pennsylvania Bar Institute's "Solving Legal Issues Across the Life Cycle of the Successful Real Estate Development Project" event on April 11, 2016, in Philadelphia, PA. Mr. Coll presented on "Joint Venture Agreements: The Marriage of Convenience" and Mr. Rosenfeldt presented on "Pre-development Contracts: Setting the Ground Rules."


DAVID S. HOUSTON

- Washington, D.C., partner **David Houston** presented on the topic of "Negotiating a Small Business Commercial Lease" at the DC Bar Pro Bono Center's training seminar on Small Business Legal Issues, on March 30, 2016.

Recognitions

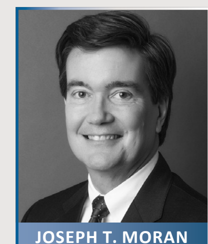
GEORGE M. MEDVED

JAYME L. BUTCHER

- Blank Rome partners **George Medved**, **Jayme L. Butcher**, **Amy J. Coles**, **James P. Hollihan**, and **Joseph T. Moran**, were ranked as the "The Top Lateral Hires of 2015" by *The Legal Intelligencer,* in recognition of their successful efforts in developing and expanding Blank Rome's footprint in Pittsburgh. One of the principal practice areas of this group is construction litigation. Please click here to learn more.

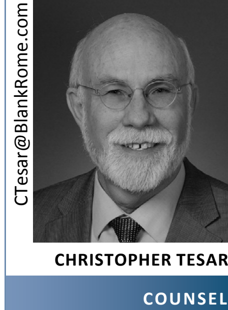
AMY JOSEPH COLES

JAMES P. HOLLIHAN


JOSEPH T. MORAN

Property Assessed Clean Energy Programs: Alternative Financing for "Green" Improvements

BY CHRISTOPHER TESAR



CTesar@BlankRome.com
CHRISTOPHER TESAR
COUNSEL

Commercial property owners are experiencing increasing regulatory and economic pressure to reduce the energy and water consumption of their projects. In 2008, the California State Legislature amended the Improvement Act of 1911 ("Act") to provide owners with a means of financing improvements to increase the energy and water efficiency of commercial properties. The Act authorizes cities, counties, and special districts to enter into voluntary property tax assessment contracts with property owners to finance permanent energy efficiency, renewable energy, and water efficiency improvements. Authorized entities have established a variety of "property assessed clean energy" ("PACE") programs to implement the legislation, but they all share a common feature: a voluntary contract with the property owner pursuant to which the owner obtains funding for "authorized improvements" that it repays via a special property tax assessment spread over the useful life of the improvements. "Authorized improvements" must have an expected useful life of at least five years, be permanently affixed to the real property, and have the capacity to reduce energy or water usage or to generate clean energy for the property.

One such program is the CaliforniaFIRST Program ("California First") of the California Statewide Communities Development Authority, a joint powers authority formed by the California State Association of Counties and the League of California Cities. California First is a growing, statewide program. Nationwide, most states and the District of Columbia now have PACE programs of different types and in various stages of implementation, which makes this financing source of national interest. A brief look at California First provides useful insight into some important issues that lenders, landlord-borrowers, and tenants should consider in connection with PACE programs.

Summary of Underwriting, Application, and Funding Process

California First's underwriting criteria are somewhat more lenient than traditional construction lending criteria, which is one of the attractions of California First. Other attractions are that 100 percent non-recourse financing is available, repayment of the funding generally is spread over the useful life of the improvements, and the funding is not "due-on-sale" if the owner disposes of the property. The underwriting criteria generally require that the owner be current with respect to its property taxes during the past three years; the owner be solvent and have a good loan payment history; the new lien amount not exceed 20 percent of the greater of the property's assessed or appraised value (as improved); the assessed or appraised value of the improved property be equal to or greater than the sum of all private debt, the principal amount of the new tax-funded indebtedness, and the aggregate principal amount of all existing tax-funded debt; and the total amount of taxes payable annually not exceed five percent of the assessed or appraised value of the improved property.

> **In deciding whether to participate** in PACE financing, the owner-landlord should review its leases carefully to determine whether the tenants must pay some or all of a proportionate share of the new tax assessments.

The owner submits a simple Initial Application to determine the eligibility of the property and the specific improvements for proposed PACE funding. Once eligibility is determined, California First issues a Conditional Reservation. The owner then has 90 days to assemble and submit a Final Application, which typically includes items such as plans and specifications, a detailed energy or water conservation audit, a budget and financing analysis, evidence of permit approval, and evidence of a construction contract with an approved project contractor. At this stage, the funding, and its specific terms and conditions, is arranged with a funding source, which California First may introduce to the owner or which the owner already may have arranged. As a practical matter, owners often obtain an expression of funding source interest before submitting the Initial Application. The application process consumes much time, effort, and expense, so none of the parties wants to undertake it unless there is a reasonable probability at the outset that a viable, funded project will emerge at the end of the process.

If California First approves the Final Application, it issues a Final Reservation, which is good for a period of one year. The parties then enter into an Agreement to Pay Assessment and Finance Improvements ("Assessment Contract"), which documents California First's agreement to fund the improvements, the owner's agreement to construct them, and the owner's agreement to repay the funding via annual property tax assessments. The funding derives from a revenue bond issued by California First and purchased by the capital source.[1] At the closing of the funding, a Notice of Assessment and Payment of Assessment Required ("Notice") is recorded and California First issues the bond. The Notice creates a lien co-equal with, but separate from, the lien of pre-existing property taxes and assessments. By law, the lien the Notice creates is superior in priority to the lien of any lender of record. Accordingly, existing lenders of record must consent in writing to the recordation of the Notice and acknowledge that the recordation will not trigger any due-on-encumbrance provisions of their loan documents. Lender consent, when necessary, is obtained (or at least pre-arranged) during the Final Application period. Actual construction of the improvements is funded via the owner's submission of a Funding Request, with verification materials, in much the same manner as a construction loan. Disbursements may be via progress payments or in a lump sum at project completion.

Lender Issues When Requested to Consent to PACE Financing

For lenders and their legal counsel, a borrower's request for consent to participate in a PACE program such as California First presents a number of issues to consider, including the following:

- A borrower's participation in a PACE program necessarily results in the lender's existing debt becoming subordinate to new borrower debt and debt service, namely, the amount the borrower finances through the PACE program and the related annual tax installments to repay the amount financed. Accordingly, the lender must condition its consent on whether the borrower, the project, and the economics of the property pre-and post-project meet the lender's underwriting criteria. If not, the lender should not consent. Important considerations are whether the energy or water conservation improvements will increase the value of the real property security or result in a more cost-efficient project that enhances the borrower's ability to service its debt.

- The lender should require amendment of its existing security instrument to evidence (a) as between the borrower and the lender, the lender's consent to the borrower's participation in the PACE program, and (b) as between the lender and any guarantor, the guarantor's consent to the borrower's participation in the program. Additional amendments should confirm that the lender's debt is subordinate to the new tax debt; when complete, the authorized improvements will constitute "real property" and secure the lender's loan (and not be subject to severance in a foreclosure or bankruptcy situation); the new tax assessments are "taxes" as defined in the security instrument, with all the attendant consequences, such as the borrower's payment obligation and the lender's right to cure delinquencies and add the cure amount to its debt to protect the lender's position; the construction of the authorized improvements is subject to all the other obligations that the borrower has under the security instrument with respect to new construction (*e.g.*, keeping the real property security free of mechanics liens); a default under the Assessment Contract constitutes a default under the loan documents; and that the parties' agreements are

(continued on page 11)

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Property Assessed Clean Energy Programs: Alternative Financing for "Green" Improvements (continued from page 10)

not intended to give any rights to third-parties, such as another lien holder that might claim that, by voluntarily agreeing to the participation, the lender loses some or all of its lien priority.

- The lender should consider requiring its borrower to provide the lender with an appropriate endorsement to its loan policy, such as an ALTA 11-06 or ALTA 11.1-06, to ensure that the modification of the lender's security instrument and the subordination of the lender's debt to the new tax assessment-funded debt do not adversely affect the enforceability of the lender's security instrument or its priority relative to the security interests of any other parties holding security interests in the property. Regarding priority, currently it is not clear whether PACE financing via property tax assessments presents a significant risk of a lender losing priority relative to a junior lien holder, but the premium for one of the foregoing endorsements generally is modest so it does not impose an undue burden on the borrower.

Landlords and tenants should assume that future landlord participation in PACE financing is likely enough that they should consider it when negotiating lease provisions that address capital improvement and tax pass-through provisions.

Issues Landlords and Tenants Should Consider

Commercial leases generally require each tenant to pay its relative share of all "taxes" relating to the project in which the tenant leases space. In deciding whether to participate in PACE financing, the owner-landlord should review its leases carefully to determine whether the tenants must pay some or all of a proportionate share of the new tax assessments. This review also will give the owner-landlord valuable information regarding the cost-effectiveness of the proposed improvements. Will the improvements actually yield positive results for the landlord's bottom line? In this regard, if most or all of the reduction in utility operating expenses will inure to the benefit of the tenants, or be offset by new property taxes that the landlord cannot pass through to the tenants (*e.g.*, because of an applicable operating expense exclusion or "cap" on the amount the landlord can pass through), then perhaps the proposed energy or water conservation project does not make economic sense. The office building or shopping center may not attract more tenants at higher rents in exchange for reduced utility expenses because prospective tenants may focus less on reduced expenses than a competing lower initial rental rate.

There are other questions. Is the lease language susceptible to the argument that the new, voluntary tax assessments for the purpose of a capital improvement are not really "taxes," but rather debt that cannot be passed through? In this regard, some leases define "taxes" less broadly than others. A definition that uses the term "*ad valorem* taxes" may not permit the landlord to pass through the new tax expense. Is it arguable that the assessments cannot be passed through to tenants because the assessments represent debt to finance capital improvements that the lease excludes from its pass-through provisions? Conversely, can the new assessments be passed through because they come within a specific, pre-authorized expense category for energy-saving or water conservation capital improvements, at least to the extent of the utility cost savings?

Of course, the obvious lesson here is that both landlords and tenants should consider PACE financing the next time they negotiate a lease that provides for operating expense, including tax expense, pass-throughs.

Conclusion

Pressure to "go green" will only increase in the coming years. Landlord-owners should consider PACE programs as potential sources of funding for green projects. A cottage industry of building contractors and capital sources has developed to assist owners in considering, funding, and implementing PACE financing for their properties. Landlords and tenants should assume that future landlord participation in PACE financing is likely enough that they should consider it when negotiating lease provisions that address capital improvement and tax pass-through provisions. Finally, lenders should develop a strategy for responding to borrower requests for consent to PACE funding because, properly done, PACE-funded programs can enhance the value of their real property security and increase their borrowers' debt service ability. □ —©2016 BLANK ROME LLP

1. The present discussion is of "Stand-Alone" bond financing. There also is a "Pooled Bond" financing alternative that aggregates financing for multiple projects.

Noteworthy Real Estate Deals

Blank Rome LLP represented:

- **Wells Fargo Bank, N.A.**, in the December 18, 2015, closing of a $2.7 billion loan under the Fannie Mae DUS program for the acquisition of Stuyvesant Town-Peter Cooper Village, the largest apartment complex in New York City.
- **DRA Advisors LLC** in its definitive agreement that was announced on December 15, 2015, for funds advised by DRA to acquire Inland Real Estate Corporation in a transaction valued at approximately $2.3 billion, including the assumption of existing debt.
- **Equinox Holdings Inc.** in its lease at 315 Park Avenue South.
- The **sale of a multifamily portfolio** of over 3,000 units located in Texas and the Southeast. Throughout the deal negotiations, Blank Rome guided the seller on strategic changes required due to the impact of oil pricing and other issues, including loan defeasance and labor arrangements.
- The **buyer in the acquisition** of the retail center known as Metro Shops at Prince George's Plaza Metro Station in Hyattsville, MD.
- A **joint venture** in connection with the acquisition of Doral Court Plaza in Miami, FL.
- The **purchaser of an 11-story commercial building** in Long Beach, CA. The purchase represents the first phase of the client's plan to redevelop the property as a mixed-use project, with 10 floors of high-end condominiums and one floor of retail.
- **Singh Development Inc.**, as contract purchaser and developer, in the zoning entitlement process for a new assisted living/memory care medical care facility in Reston, VA. The project consists of a new 155,000 square foot building containing 136 dwelling units on 24 acres of land.

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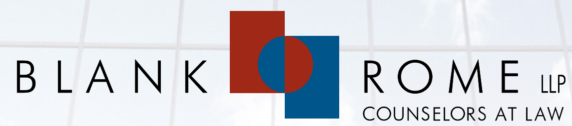

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