

2018 Real Estate Update: Trending Issues & Topics of Interest

Greenbaum, Rowe, Smith & Davis LLP Client Alert
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Each year, the attorneys in our Real Estate practice area bring their expertise and insight to bear by contributing an article for this Update, which is sent to our clients and business contacts to highlight topics of significance to those with interests in the commercial and industrial real estate sectors.

The subjects addressed in this year's Update cover many bases, and are reflective of what our lawyers encounter in their daily practices. The articles offer best practices and strategic pointers; they provide clarity and perspective on complex issues; they analyze current concerns and look ahead to developing trends.

The focus is on real estate, however because our firm is multi-disciplinary and highly collaborative in nature, there's also an article summarizing the impact of the new tax law on the owners of real estate, written by members of our tax and estate practice.

We welcome your feedback on this publication, and if a particular article whets your appetite for more information, we are always available to answer your questions. If you'd like to discuss any of the issues presented and their potential bearing on your individual portfolio and overall business strategy, please get in touch.

The Business of Marijuana: How Will It Affect The Real Estate Sector?

Jack Fersko and Mitchel S. Kay

Marijuana use for medicinal purposes can be traced to 2737 BC China where it reportedly was used to treat multiple ailments. Its use as a recommended treatment for certain conditions can be found in U.S. medical journals by the late 1700s. The landscape changed, however, and marijuana ultimately became, and remains, a Schedule I drug under the federal Controlled Substances Act. Nevertheless, as of this writing, 29 states have legalized marijuana for medicinal purposes and 9 states and

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the District of Colombia have legalized marijuana for recreational use. It is predicted that the field will grow to a \$50 billion industry by 2026.

The impact of the cannabis industry on real estate markets with legalized recreational use has been extraordinary. Industrial rents are reported to have risen 33% from the first quarter 2014 through May 2017 in Denver, and 27% in Seattle and Portland, compared with a 19% increase in 54 of the other largest U.S. markets. Sales price premiums are reported between 20% - 40%.

Although New Jersey legalized medical marijuana in 2010, only 6 facilities have been licensed to date. Governor Murphy is clear on his intention to legalize recreational marijuana, and the expectation is that New Jersey will rapidly become one of the major cannabis markets in the country.

Legalization will present a number of issues impacting the use, growing, selling and dispensing of marijuana. As marijuana remains illegal under federal law, landlords and tenants will have to properly address lease provisions that are otherwise "boilerplate," including compliance with laws, permitted use, maintenance, common area responsibility, default, termination, abandonment and indemnity. Property managers need to consider a host of issues, including, as an example, tenants' rights to reasonable accommodations, the right to grow and smoke marijuana, and security concerns. Marijuana operations also pose unique insurance issues that stem from the high usage of water, the highly flammable nature of certain processing techniques, and the increased need for security. There also are title insurance issues, as title insurers have indicated they will not close or insure a transaction involving land associated with the marijuana industry.

Tax and other economic issues must also be addressed. Section 280E of the I.R.C. disallows deductions for expenses incurred in the business of producing or selling marijuana. There were a series of Justice Department guidance documents that enabled the industry to exist. On January 4, 2018, however, Attorney General Sessions rescinded these guidance documents but left actual prosecution to individual federal prosecutors' determination, consistent with chapter 9-27.000 of the U.S. Attorneys' Manual. The manual requires federal prosecutors to examine a number of factors in determining whether to bring a prosecution, including federal law enforcement priorities, the seriousness of a crime, the impact of a crime on the community and the deterrent effect of prosecution. The Financial Crimes Enforcement Network (FinCEN) has issued guidance for banks to provide services to the marijuana industry while abiding their obligations under the Bank Secrecy Act. Although tied to the rescinded Justice Department guidance documents, the FinCEN guidance has not been rescinded by the Department of the Treasury - perhaps not unmindful of the tremendous taxes generated at the federal level by the marijuana industry. And recent federal appropriations bills (set to expire at midnight on March 23) have barred the Department of Justice from utilizing appropriated funds to interfere with states implementing their own medical marijuana laws. It will be important to keep abreast of any change in federal prosecutions, whether the Department of the Treasury amends or rescinds its guidance and Congressional appropriations.

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A comprehensive bill presently is pending (S830 - Scutari) to legalize recreational marijuana in New Jersey. State Assemblyman Reed Gusciora also introduced a bill (A1348). Although a host of issues will require resolution before final legislation is enacted and regulations promulgated, there are preparatory measures that should be examined now by those contemplating entry into the field.

Real Estate Taxes: New Jersey Towns Go On The Defensive

Thomas J. Denitzio, Jr.

Federal income tax reform, by limiting the deduction for state and local taxes, has placed a bright spotlight on real estate taxes here in New Jersey, where property owners bear one of the heaviest tax burdens in the country. Despite the musing of Treasury Secretary Mnuchin that local governments should concentrate on cutting their budgets and thereby provide tax relief, the focus instead has been - and will continue to be on - raising revenue.

It is no surprise, then, that tax exempt properties have come under closer scrutiny. For example, as the result of a New Jersey Tax Court opinion in 2015 involving Morristown General Hospital, many non-profit hospitals have been sued to revoke their longstanding tax exemptions on the basis that they operate with many characteristics of a for-profit hospital. Municipalities where such hospitals operate have been aggressive in pursuing tax payments. Legislation has been introduced, but not yet enacted, in an attempt to strike a balance between the competing interests of the hospitals and their host communities.

In addition, some municipalities have filed tax appeals seeking to increase the assessments of commercial properties set by their own tax assessors. This frequently occurs where the municipality obtains appraisal evidence that a particular class of properties, such as office buildings, are under-assessed. In a recent decision, the Pennsylvania Supreme Court declared that such practices violate the Uniformity Clause of the Pennsylvania Constitution. New Jersey has a similar provision in its Constitution but there has been no ruling by the New Jersey Supreme Court on this issue.

The growing demand for government services, the increasing cost of providing those services, the well-documented need for extensive infrastructure repairs, not to mention the tax refunds paid as a result of successful tax appeals, will undoubtedly cause taxing districts to explore new ways to increase tax revenue. Whether real estate tax assessments warrant a reduction or a municipality commences an appeal challenging an exemption or seeking an assessment increase, property owners are cautioned to seek experienced legal advice.

Proposed Legislative Changes to PILOT Programs May Negatively Impact Redevelopment in 2018

Robert S. Goldsmith and Steven G. Mlenak

For decades, New Jersey has experienced notable success with redeveloping many of its distressed areas by affording municipalities the ability to provide tax incentives to redevelopers (e.g., PILOTs). These incentives encourage redevelopers to accept the substantial risks and additional costs that come with

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most redevelopment projects - for example, the risk factor for unknown markets and the often-required construction of structured parking (at a cost of roughly \$25,000 per space vs. \$3,000 per space in a surface lot). Without such incentives, many of the highly touted redevelopment projects that have revitalized many of the state's distressed areas would have been economically infeasible. Despite this proven track record of success, there are two bills pending before the New Jersey Legislature which could inhibit many redevelopment projects.

S867, entitled *"Imposes prevailing wage for public work on properties receiving tax abatements or exemptions,"* would require that redevelopers pay prevailing wage for the construction of projects approved for a tax abatement or tax exemption, unless the property or premises is already exempt from taxation.

The general purpose of tax abatements and tax incentives is to provide an opportunity for redevelopers to overcome the gap between what a project will cost and its projected income. By statute, such incentives should only be given to redevelopers who prove that the cost of the construction makes the project incapable of being completed without the abatement/exemption. Even with such incentives, many successful redevelopment projects in New Jersey have operated with razor-thin margins. Imposing prevailing wage upon such projects could serve to neutralize the benefit of the abatement/exemption by imposing what some believe to be additional costs in the range of 20-30% for prevailing wage. These additional costs would likely eat up the savings obtained by the abatement, therefore rendering many redevelopment projects economically infeasible.

S59, entitled *"Requires municipalities to share certain payments received in lieu of property taxes with school districts; informs counties and school districts of application for property tax exemptions,"* would require that municipalities receiving payments in lieu of taxes (PILOT) remit a portion of such payments to its school district(s), including regional school districts, in an amount calculated by multiplying the number of school-age children attending public school that reside in an approved project by the district's budgetary cost per pupil. The redeveloper responsible for making the PILOT payments would be required to certify in their annual audit the number of school-age children residing within the approved project who attend public school.

S59 would essentially remove the financial incentive that municipalities would have to enter into PILOT arrangements for residential projects, although the bill would likely have a minimal impact on industrial or commercial projects. In addition to greatly reducing a municipality's take-home revenue from the PILOT, municipalities would be forced to undertake significant risk when granting tax abatements for residential projects. Conceivably, as there are no caps or restrictions on the amount of the proceeds to be sent to the school district, a residential project with a high percentage of school-age children could result in the municipality having to remit its entire revenue to the school district(s), thus resulting in less revenue than had the municipality denied the application. It is likely that this bill will see some municipalities attempting to shift that risk to the redeveloper to cover some or all of this payment to the school district(s), thus increasing the redeveloper's risk. With the passage of the recent federal tax reforms affecting the housing industry, the uncertainty to developers is even greater.

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Should S59 be adopted, redevelopers should also be cautious of housing discrimination issues, as a redeveloper, knowing that they will be responsible for tens of thousands of dollars per child, could inadvertently violate anti-discrimination laws by marketing their dwellings to encourage non-families.

Yet another issue to consider is that S59 does not address the actual costs of schoolchildren, but instead generalizes those costs to the average cost per pupil in that district. If a school district has a budget of \$1 million with 100 students, its average cost per pupil is \$10,000. If a new student enrolls in the district, the cost of running the district does not increase to \$1,010,000. Rather, in all likelihood, the average cost per pupil would be reduced to around \$9,900. No new teachers or staff would be hired, and no buildings would need to be constructed. There would be no incurred capital costs. It is likely a matter of some additional supplies. Even if a redevelopment project added ten or twenty schoolchildren, they would likely be of varying ages and spread out at various grade levels. Further, research has revealed that affordable housing projects typically yield a higher number of schoolchildren than market-rate units. This bill, therefore, could have the unintended consequence of discouraging affordable housing.

We will be tracking the status of this legislation closely and will keep our clients advised regarding any developments, as it is important that property owners and land developers stay cognizant of the proposed legislative changes to programs such as PILOT.

The End of LIBOR

Lydia C. Stefanowicz and **Charles J. Wilkes**

Borrowers and lenders who have or are negotiating credit facilities with LIBOR-based interest rates need to be aware that LIBOR is in the process of being phased out. Parties should review and understand what their loan documents, swap documents and other financial contracts say about how interest will be calculated in the absence of LIBOR, which is slated to be eliminated by the end of 2021, if not sooner.

LIBOR is an acronym for London Inter-bank Offered Rate. Since the 1970's, LIBOR has evolved to become the preferred benchmark for short-term interest rates. It has been estimated that over \$350 trillion worth of financial derivative contracts, mortgages, bonds, and commercial and consumer loans bear interest at rates based on LIBOR.

Why change a benchmark that is so widely used?

Originally, LIBOR was the average interest rate at which a bank could borrow from leading banks in London, and was ascertained on an individual basis by the bank making the loan. In 1986, the British Bankers Association (BBA), a U.K. trade organization, took over the administration of LIBOR and began to compile and publish the rates. Various investigations after the 2008 financial crisis revealed that since the early 1990s, BBA had colluded with reporting banks to falsely inflate or deflate rates to their advantage. By 2012, the breadth of the manipulation scandal had become evident and about 20 major banks worldwide were the subject of criminal and civil investigations and lawsuits. Thereafter, the Financial Conduct Authority (FCA), a U.K. regulatory agency, assumed responsibility for overseeing LIBOR.

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While regulatory reform could overcome the problem of market manipulation, post-financial crisis regulation also diminished bank appetite to make wholesale loans. As a result, banks now rely on judgment calls more than actual transactions to set LIBOR. In 2017, FCA CEO Andrew Bailey, in a widely-reported speech, questioned the sustainability of LIBOR as a benchmark. Bailey noted that "the underlying market that LIBOR seeks to measure-the market for unsecured wholesale term lending to banks-is no longer sufficiently active." According to Bailey, "[i]f an active market does not exist, how can even the best run benchmark measure it?" Acknowledging that the unexpected and unplanned disappearance of LIBOR would cause market disruption, Bailey announced that the current panel banks had agreed voluntarily to sustain LIBOR until the end of 2021 to allow time for a transition to alternative reference rates that are based on actual transactions.

What will replace LIBOR?

In a press release published on December 14, 2017, the U.S. Federal Reserve Board released final plans to create three new reference rates based on overnight repurchase agreements (commonly known as "repos" and pursuant to which banks lend money to each other on a secured basis), including the Secured Overnight Financing Rate (SOFR), which is the recommended alternative to U.S. Dollar LIBOR. SOFR is based on a variety of repurchase transactions and is the broadest of the proposed reference rates. However, SOFR does not yet actually exist. The Federal Reserve is expected to collect and tabulate relevant data and begin publishing SOFR in the second quarter of 2018. At this writing, we do not know enough about SOFR to even speculate as to how this new rate will function in place of LIBOR.

Apart from that uncertainty, this recent action by the Federal Reserve does not solve the problems that arise from the end of LIBOR. This new benchmark will not be a successor rate to LIBOR in any technical sense, as it will be calculated very differently. The most notable difference is that SOFR will be based on secured transactions, while LIBOR reflected the pricing on unsecured transactions. As a result, there is no reason to believe that financial contracts with pricing based on LIBOR will be construed, wholesale, to have intended that this new rate replace LIBOR (with whatever effect that may have on pricing).

Thus, prudence dictates that all financial contracts that utilize LIBOR as a reference rate and have a term extending beyond 2021 (or even earlier, if the lender has a right to reprice in the event LIBOR cannot adequately be determined or if LIBOR fails to cover the lender's cost of funds) need to be reviewed to identify the other party's rights in the event that LIBOR is no longer available, and to further ascertain if the alternative (if any) provided in those contracts is both workable and will result in pricing reasonably equivalent to LIBOR.

For example, a traditional credit agreement may include a boilerplate provision that if LIBOR is unavailable, the lender has the right to switch to Prime Rate pricing. The problem in that case is that the current Prime Rate is 4.50% per annum, while one month LIBOR is 1.57%. Even with the lower "spread" or margin that usually goes with Prime Rate pricing, a borrower will be paying a higher interest rate. The Prime Rate alternative to LIBOR was never intended to be a long term solution; it was designed to operate when a temporary disruption of the financial markets prevented the lender from timely obtaining a LIBOR

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quote in the short term. In addition, if the parties are forced to rely on a provision of this type for any period of time, there will be a mismatch with the terms of any applicable interest rate swap. That is, interest rate swaps tied to LIBOR may no longer be effective to hedge against the floating rate obligations they were intended to cover.

In recent years, as the potential for financial market disruptions became more evident, the variety of alternative rate provisions included among the boilerplate in credit agreements has grown to include provisions that do not simply state a certain specified alternative interest rate, but instead provide the lender with an often vaguely-stated right to re-price if LIBOR becomes unavailable. Consider, for example, the implications for the borrower of a provision that permits the lender to substitute for LIBOR a rate determined by the lender from "another recognized source or interbank quotation." The variations on such alternative rate provisions are nearly unlimited. And there is no assurance that the alternative rate provisions in a swap contract match the alternative rate provisions in the covered credit agreement.

We recommend that borrowers and lenders review LIBOR-based interest rate pricing provisions in both pending and existing credit and other financial contracts and come to an agreement on interest rate pricing post-LIBOR. Modifying LIBOR-based interest rate provisions now is the best way to avoid confusion, unintended consequences and increased costs in the near future.

The New Tax Law's Impact on Real Estate

Jo Ann Gambale and **Brian R. Selvin**

The New Year brings with it a new tax law - the Tax Cuts and Jobs Act - that impacts the owners of real estate in many ways. This article presents an overview of those changes.

Limitation on Mortgage Interest Deductions

For taxpayers who purchase new homes, interest will be deductible only on up to \$750,000 of "acquisition indebtedness." This is debt to acquire, or make substantial improvements to, a personal residence. Under the prior law, interest was deductible on up to \$1 million of debt. The prior law, with its \$1 million limit, will continue to apply to any mortgages that were taken out before December 15, 2017, as well as any debt that is refinanced after this date provided the refinancing does not exceed the amount of the refinanced debt.

Interest on home equity loans and home equity lines of credit (HELOCs) are no longer tax deductible, unless the proceeds are used to make substantial improvements AND when combined with any other acquisition indebtedness, does not exceed the \$750,000 limit. The loss of the deduction for home equity loans includes both new and existing home equity loans and lines of credit.

Limitation on State and Local Tax (SALT) Deduction

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In addition to the limitation on deducting home mortgage interest, there is now a limit on the deduction for state and local taxes - only allowing for a maximum deduction of \$10,000 (\$5,000 if married and filing separately) for all state and local income taxes combined (i.e. property, sales, and income taxes).

Section 1031 - Like-Kind Exchanges

As a result of the new law, only real estate will qualify for Section 1031 like-kind exchanges. Taxpayers will no longer have the ability to do a like-kind exchange of personal property, such as artwork, airplanes, trucks, machinery and equipment.

Partnerships, Limited Liability Companies and Sole Proprietors

Since corporate taxpayers saw their income tax rate drop from 35% to 21%, the new tax law also provides a benefit to owners of pass-through entities (i.e. partnerships, limited liability companies, S corporations, and sole proprietorships). Generally, the owners of these entities are entitled to a 20% deduction on their share of the passed-through income. However, this benefit is subject to various limitations:

- Only income from a trade or business is subject to the deduction. Interest, dividends, and capital gains that are passed through are not eligible for the deduction.
- An owner of a trade or business that primarily involves the performance of services (other than engineering and architecture) will not be entitled to the deduction. This exclusion, however, does not apply if the owner's total taxable income (from all sources) does not exceed \$157,500 (\$315,000 for joint filers). The exclusion applies in part to owners with taxable income between \$157,500 and \$207,500 (between \$315,000 and \$415,000 for joint filers).
- An owner of a non-service trade or business whose total taxable income exceeds \$157,500 (\$315,000) will be subject to the "wage limitation." This means that the 20% deduction will only be available to the extent of the greater of: (1) 50% of the owner's percent of the entity's total wages as reported on its W-2 tax forms; or (2) a formula using both wages and the entity's capital investment (i.e. the owner's share of 25% of wages + 2.5% of the entity's unadjusted basis in its depreciable property).

The availability of this deduction expires after 2025.

Business Interest Deduction

The new law provides that taxpayers will not be able to deduct business interest expenses above 30% of EBITDA (earnings before interest, taxes, depreciation and amortization) until the end of 2021, and limits the interest expense to 30% of EBIT (earnings before interest and taxes) starting in 2022. However, investors in real estate (both pass-through entities and REITs) are permitted to elect out of the 30% limitation rule. If they opt out, however, they will face a longer cost recovery period for depreciation on their property.

REITs

REITs will continue to be a popular vehicle for real estate investment, as they have received favorable treatment under the new law. Investors in REITs will enjoy the same 20% deduction for business income enjoyed by pass-through business owners for ordinary REIT dividends. The deduction will not apply to capital gains and qualified dividend income, which will continue to be taxed at the same favorable rates as before. Furthermore, while interest income received from a mortgage investment is not subject to the 20% business income deduction, the ordinary dividends received from a Mortgage REIT do qualify for the deduction.

Depreciation

The new law provides for a 15 year recovery period for qualified improvements, eliminating the separate definitions of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. It also extends and modifies bonus depreciation by allowing businesses to deduct 100% of the cost of eligible property in the year it is placed in service, as long as it is before 2022. After that, the amount of allowable bonus depreciation will be phased out over four years - 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026. The new law also doubles the limitation on the amount that can be expensed under Section 179 (rather than capitalized) each year from \$500,000 to \$1 million, and expands the classification of qualified property.

While the Senate version of the new law would have decreased the recovery period for real estate, the final version did not enact any changes to the MACRS recovery periods of 39 and 27.5 years for nonresidential and residential rental property, respectively. It did, however, reduce the ADS recovery period for residential rental property from 40 years to 30 years for property placed in service after 2017.

Finally, the new law contains a provision in Section 168(g)(3)(B) that was intended to give qualified improvement property (other than leaseholds, restaurants and retail) a 20 year ADS recovery period instead of 40 years. However, the provision intended to accomplish such, Section 168(e)(3)(D)(v), was not included in the final version of the law, thereby leaving us with what Tony Nitti in Forbes described as "a stairway to nowhere."

Owners of real estate are advised to consult with an experienced tax attorney or other tax professional to ascertain the specific impact of the new law on their circumstances.

Controlling Interest Transfer Tax - Buyer Beware

Anthony Giountikos and **Regina E. Schneller**

At the recording of a deed for the transfer of real property in New Jersey, the Realty Transfer Fee is imposed on the seller and the Mansion Tax may be imposed on the buyer. However, non-deed transfers of interests in certain entities that own real property may result in a Controlling Interest Transfer Tax being

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imposed on the buyer.

The Controlling Interest Transfer Tax was enacted in 2006. Essentially, upon the sale or transfer of a controlling interest in an entity which possesses, directly or indirectly, an interest in "classified" real property for consideration in excess of \$1,000,000, a tax is payable by the buyer of the controlling interest in the amount of 1% of the consideration. A "controlling interest" is defined to mean, in the case of a corporation, more than 50% of the total combined voting power of all classes of stock of the corporation; and, in the case of a partnership, association, trust or other organization, more than 50% of the beneficial ownership of the commercial real property of that entity. Classified real property means Class 4A commercial property (e.g., office buildings and shopping centers). It does not apply to vacant land, multi-family or industrial properties.

In the case of a sale or transfer of a controlling interest in an entity which, in addition to an interest in classified real property, also possesses, directly or indirectly, interests in other property (real or personal), a tax is due on the sale or transfer only if the equalized assessed value of the classified real property exceeds \$1,000,000, in which event the buyer pays a tax equal to 1% of the equalized assessed value of the classified real property that is equal to the percentage of the ownership interest sold or transferred.

If a series of transactions occurs over a period of six months in either of the two foregoing sale or transfer scenarios, the series of transactions is presumed to be a single sale or transfer and is subject to the Controlling Interest Transfer Tax.

The Controlling Interest Transfer Tax is due on or before the last day of the month following the month in which the sale or transfer of the controlling interest is completed. The buyer must file a return on Form CITT-1 with the New Jersey Division of Taxation. A separate statement of waiver, Form CITT-1E, must be filed if an exemption is claimed.

The Controlling Interest Transfer Tax does not apply in the following situations: (a) transfers by or to the United States, the State of New Jersey, or any of their instrumentalities, agencies or subdivisions; (b) a purchase by a tax exempt entity under Section 501(c)(3) of the Internal Revenue Code; (c) transactions exempt from the Realty Transfer Fee enumerated in N.J.S.A 46:15-10; and transactions incidental to a corporate merger or acquisition if the equalized assessed value of the real property transferred is less than 20% of the total value of all assets exchanged in the merger or acquisition.

In order to avoid any possible adverse financial impact that may result from failure to comply with the filing of the necessary forms and payment of the Controlling Interest Transfer Tax, if applicable, competent legal advice should be sought when contemplating a non-deed sale or transfer of a controlling interest of an entity in New Jersey.

Case Study: Handling an Acquisition Transaction with Multi-Disciplinary Legal Issues

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Senwan H. Akhtar and **Hal W. Mandel**

The firm recently represented a client in its acquisition of a portfolio of supermarkets and affiliated real estate for over \$10 million. The acquisition involved the purchase of the equity interests of individual members of the companies that owned the supermarkets and the real estate. This complex transaction required the collaborative efforts of a team of attorneys working within the firm's corporate, real estate, tax, environmental and litigation practice areas.

The client initially advised us that the bank holding a mortgage on one of the supermarket properties had obtained a foreclosure judgment relating to the property. Our client wanted to purchase the foreclosure judgment, which would allow them to become the owner of the property at a substantially discounted price. Our litigation department quickly negotiated and closed on a loan sale agreement with the bank which resulted in our client becoming the holder of the foreclosure judgment. Upon the closing of the sheriff's sale, our client will own the supermarket property.

Two other supermarket properties were subject to existing mortgages and a tax lien. Our team both restructured the existing loans and negotiated an agreement with the holder of the tax lien to cancel the lien in order to avoid a foreclosure of the property. In addition, one of the properties was subject to a redevelopment agreement. We advised our client on the steps necessary to maintain the benefits of the reduced real estate taxes obtained through that redevelopment agreement.

During the course of negotiating the transaction, we learned that one of the members who was selling his equity interests was planning to operate a neighboring commercial property after the closing. To protect our client's investment and avoid the possibility of that individual becoming a competitor, we successfully negotiated the preparation and recording of a restrictive covenant on the neighboring property that prohibits its use as a supermarket.

In addition to navigating the complex real estate issues involved in this transaction, we leveraged our extensive experience in supermarket acquisitions and dispositions to effectively provide counsel on federal and state issues that affect supermarkets and certain related industries. For instance, we advised our client on compliance with state laws relating to litter control fees and state and federal laws relating to certain licenses, such as those relating to state and federal nutritional assistance programs (WIC and SNAP - commonly known as food stamps). Our tax and corporate attorneys provided counsel on compliance with the "employer mandate" of the Affordable Care Act (ACA). Our team also negotiated and prepared operating agreements and employment agreements among the individuals comprising the purchaser group.

Our ability to staff this transaction with attorneys from multiple disciplines enabled our client to benefit from our practical experience and receive sophisticated advice in each area of law that was associated with this matter.

Affordable Housing Determinations Are Nearing Completion

Steven Firkser and Robert Beckelman

For the past three years, the New Jersey courts have been undertaking the determination of affordable housing obligations in New Jersey's 565 municipalities. 2018 may finally see trial court findings for most of the State.

The courts have assumed control over affordable housing determinations because of the failure of the Council on Affordable Housing (COAH) to adopt regulations defining municipalities' obligations to ensure the construction of housing for low and moderate income families. In March 2015, the New Jersey Supreme Court determined that COAH had failed in its responsibilities and required the trial courts in each county to make those determinations. More than 375 municipalities filed declaratory judgment actions in 2015, and the trial courts appointed special masters to assist in determining the municipal obligations for affordable housing.

The municipalities and housing advocates have retained experts, and the numbers produced by those experts are widely disparate. In one notable trial involving South Brunswick in 2016, the court imposed an obligation of 1,500 units as promoted by housing advocates, rejecting the findings of the municipal expert with much lower numbers. South Brunswick has challenged that decision and it is proceeding through appeals. Ocean County was also lined up to proceed to trial in 2016, but the uncertainty and cost of trial led to a flurry of settlements.

In January 2017, the New Jersey Supreme Court held that municipalities must also account for the housing needs that accumulated between the years of 1999 - 2015, the "gap period" during which COAH failed to adopt and implement rules that could survive legal challenges, and this further increased the housing obligation on municipalities. The first extensive trial since that ruling has been conducted before Judge Jacobson in Mercer County, with other trial courts awaiting Judge Jacobson's decision before proceeding. The trial before Judge Jacobson began in January 2017, entailed more than 40 days of testimony, and the decision is expected early in 2018. Her decision should carry considerable weight with the other trial judges.

As a result of the uncertainty and the possibility of another court ruling imposing high numbers on municipalities, more than half of the municipalities have entered into settlements with the leading housing advocate, Fair Share Housing Center, as well as with developers who have intervened in some cases. Municipalities have agreed to numbers between 50% - 75% of the high numbers in Fair Share's expert report, in order to obtain certainty and avoid the cost of further litigation. To date, Fair Share Housing Center has entered into settlements with more than 170 municipalities and reports that it has seen more success with court-administered enforcement than anything before COAH during the past two decades.

While awaiting Judge Jacobson's decision, there are still opportunities for property owners willing to provide affordable housing on their properties. Judge Jacobson has appointed an independent expert to determine the obligations that each municipality must achieve, and this expert has concluded that those

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obligations would fall within a middle ground of approximately 60% of the high numbers suggested by the housing advocates. That would impose significant obligations on the municipalities to find sites for affordable housing.

Once the housing obligation is fixed, municipalities must find ways to achieve compliance. This could provide opportunities for developers who can offer developments with affordable units (generally 15% - 20%) to assist the municipalities in meeting their obligations. Further, when municipalities present their housing plans, interested developers will also have the opportunity to contest the validity of those plans and seek to include their properties with an affordable housing component.

To Buy or Not to Buy a Contaminated Property - That is the Question!

Ann M. Waeger

As the industrial real estate market continues to boom in New Jersey, the availability of large tracts of land on which to build industrial buildings, including large warehouse buildings in advantageous locations, appears to be shrinking. As a result, we have noticed a trend where buyers are now considering the purchase of properties with unresolved environmental issues that they never would have considered in the past due to internal risk management protocols and pressure from their lenders.

Evaluating and addressing the risks associated with a property that is part of (or near) a federal or state Superfund site, a former municipal landfill, or a former gas station or drycleaner site - and has not yet been remediated - can be a daunting process.

While each property will have its own unique issues and set of challenges, here is a sampling of the types of risk management tools that can be utilized in connection with assessing the viability of such an acquisition.

1. Conduct aggressive due diligence. This includes a review of environmental documents, as well as the hiring of a reputable environmental consulting company to perform a thorough review of the property (including a Phase I/Preliminary Assessment Report and possibly a Phase II investigation). Even if the seller of the property has performed or is currently performing its own investigation or remediation of the property, the buyer needs to perform its own due diligence for any number of reasons. These include taking advantage of available statutory innocent purchaser protections and obtaining an independent evaluation as to the environmental status of the property.
2. Use the purchase and sale agreement as a mechanism to allocate environmental risks, including representations and warranties, escrows, releases, indemnities and potentially the retention of environmental liabilities by the seller, or more often the assumption of environmental responsibilities by the buyer.
3. Explore the possibility of hiring a company to perform a "guaranteed fixed price remediation" in connection with the project. This may assist the buyer in getting its "arms" around the potential costs of remediation. Keep in mind, however, that this type of remediation includes not only the

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estimated cost to perform the remediation, but also additional costs for the risks that the contractor is assuming when it provides a guaranteed fixed price.

4. Purchase an environmental liability insurance policy. These policies have several different types of coverage that might be available in connection with the purchase of a contaminated property. These include: bodily injury and property damage coverage for pre-existing and new pollution conditions; cleanup cost coverage for unknown pre-existing pollution conditions and, in certain circumstances, known pre-existing pollution conditions, as well as cleanup cost coverage for new pollution conditions; coverage for off-site transportation and disposal of pollution conditions; defense cost coverage; and business interruption coverage. Policies generally offer policy limits of up to \$25,000,000 (although more may be available), deductibles of \$25,000 and up, and terms of 1-10 years (but usually not more than 5 years for new pollution conditions). This market is very robust and an insured may be able to negotiate creative coverage to help address the unique risks associated with the transaction. There are also two insurance companies that now offer cleanup cost cap coverage in limited circumstances.

While there are certainly risks associated with purchasing a contaminated property, by utilizing environmental risk management tools such as those described above, a buyer may gain sufficient comfort to move forward with the purchase.

The Misunderstood Good Guy Guaranty

Steven C. Delinko

In the practice of leasing commercial real estate, full payment and performance personal guaranties (individual or corporate) are not uncommon, and are often an integral part of the transaction. When dealing with a newly-formed tenant entity or a marginally creditworthy tenant entity, a personal guaranty of the lease by another party is often required by the landlord to provide additional security for the tenant's payment and performance obligations under the lease - namely, another party or entity to pay or perform the tenant's obligations in the event the tenant fails to do so itself.

During the course of negotiations, the full payment and performance personal guaranty may very well become subject to common limitations, including: (i) a "dollar limitation" beyond which the guarantor will not be liable; (ii) a "duration limitation" providing a specific date after which the guarantor will no longer be liable; (iii) a "net worth test" for the tenant which, once achieved by the tenant, will relieve the guarantor from its liability, and (iv) a "Good Guy Guaranty" provision.

As the saying goes, however, "the devil is in the details" in order to avoid misunderstandings that may arise when the phrase "Good Guy Guaranty" is used in a negotiation. The "details" are the varied conditions and obligations that become a condition precedent to the release of the guarantor.

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The Good Guy Guaranty appears to have originated in New York in the late 1970s and 1980s, when commercial landlords wanted to discourage tenants from defaulting in their leases and continuing to operate rent-free pending a long and costly eviction period. Recently, we have seen a significant increase in the use of the Good Guy Guaranty in New Jersey and New York commercial real estate leasing transactions.

A Good Guy Guaranty provision secures a commercial lease by ensuring that the landlord regains possession of the leased property on a specific date, with the leased property being surrendered to the landlord in the condition required under the lease. The Good Guy Guaranty will contain a provision whereby the Guarantor is released from its personal liability by providing the landlord with "xxx" amount of prior written notice of a "vacate date" on which the Guarantor guarantees that the tenant surrender possession of the leased property to the landlord in the condition required under the lease. The Good Guy Guaranty will often require the payment of some monetary consideration to the landlord for the release of the Guarantor - this consideration may take the form of a forfeiture by the tenant of all or a portion of the security deposit maintained by the landlord under the lease.

The release of the Guarantor will also be conditioned upon the Guarantor guarantying that the tenant will not be in default in any of the terms of the lease, including the payment of rent and additional rent, at any time prior to the "vacate date." If the tenant defaults in its lease at any time prior to the "vacate date," or fails to actually vacate and surrender to the landlord the leased property in the condition required under the lease, the Guarantor's liability under the Good Guy Guaranty will continue in all respects, and the Guarantor will remain liable for the full and punctual performance and observance by the tenant of all the terms of the lease on the tenant's part to be performed.

It is noteworthy to mention that the Good Guy Guaranty releases only the Guarantor from its personal liability under the lease. The tenant remains liable for the tenant's obligations under the lease, albeit the tenant, at the time, may no longer be creditworthy. Nonetheless, the Good Guy Guaranty can be integral to the transaction by providing the Guarantor with relief from personal liability, providing security to the landlord for a specific time, and most importantly, returning the leased property to the landlord - vacant, and unencumbered, and otherwise in the condition required under the lease. This saves the landlord the time and expense necessary to regain possession and restore the leased property, enabling the landlord to begin re-marketing its property early, and when the landlord still enjoys the rental income stream.

Changes to AIA Construction Agreements Released in 2017 Should be Noted

Kenneth T. Bills

The American Association of Architects (AIA) released updated and revised versions of most of its family of construction agreements during 2017. The AIA forms of construction documents, which are updated every ten years, are the most widely used form of agreements in the commercial construction industry, so contractors, subcontractors, property owners, architects and other design professionals are all likely to encounter the revised documents in the course of business.

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While the 2017 changes are more evolutionary than revolutionary, the revisions still require careful attention. Significant changes to the principal "A" series construction contracts, designed to be used by owners and contractors, include, among many other changes, (i) increased prominence for liquidated damages for late completion, (ii) a new section for insertion of bonus and incentives for early completion; (iii) a provision for a termination fee to be negotiated in the event the owner terminates for convenience; (iv) streamlined terms for the calculation of progress payments and (v) more detailed and nuanced treatment of retainage.

One of the most significant revisions to the A101, A102 and A103 construction contracts is that insurance requirements are now addressed in a 7-page exhibit that provides a much more sophisticated approach to insurance issues. By moving insurance to an exhibit to the contract, owners and contractors can also more easily provide the insurance exhibit to their insurance advisors for review. This reflects the increasing importance and complexity of insurance in construction contracts, and the need for careful attention to insurance requirements.

The A201 General Conditions that are incorporated by reference into the AIA's construction contracts (other than the short form or abbreviated form) was also significantly revised. For example, a contractor is given the right not to commence work if an owner fails to provide evidence of its financial arrangements to pay for the initial scope of the work. Thereafter, the contractor can stop work if the owner fails to respond to a request for evidence of financial ability if requested after a material increase in the contract sum due to changes in the work, late payments by the owner, or reasonable concerns about the owner's ability to pay. The revised A201 also places on owners an affirmative obligation to notify the architect of the substance of all direct communications between the owner and contractor, which may be an unworkable obligation. There are numerous other revisions as well.

The 2017 revisions also include the principal owner-architect forms (B101 through B105), the primary AIA form of subcontract (A401), and many of the AIA's administrative and specialty documents.

The release of the 2017 AIA documents has many implications. For owners and others who do not normally use AIA documents, it is important to recognize that although the AIA construction documents are widely used, as with any form of contract, they are a starting point only and need to be carefully tailored to the needs of each party and the demands of the particular transaction. When presented with a proposed contract on an AIA form, a party should have it reviewed and customized by an attorney knowledgeable about the documents strengths and weaknesses.

There are implications for the many developers, contractors, subcontractors and design professionals who regularly use the existing AIA 2007 documents as well. Many users have developed their own customizations and riders that are appropriate for the existing 2007 AIA documents. After an eighteen month phase-in period, which for many of the AIA documents will end in October of 2018, use of the 2007 versions will no longer be permitted. As a result, even those parties active in the construction industry will need to develop new riders and modifications to address the 2017 AIA form agreements.

2017 Appellate Ruling Interprets "Time of Application" Rule: Appeal is Pending

John H. Hague

A case of first impression, *Dunbar Homes, Inc. v. Zoning Board of Adjustment of the Township of Franklin*, was decided by the Appellate Division of the New Jersey Supreme Court and approved for publication February 14, 2017.

The opinion interprets New Jersey's "Time of Application Rule," the purpose of which is to insulate applications, upon filing, from newly enacted intervening ordinances designed to alter or prevent a project. Based on the Rule, the ordinances in effect at the time of application control, as opposed to those in effect at the time of decision on the application.

The Appellate ruling in *Dunbar* establishes, for the first time, what an "application" is for purposes of satisfying the Rule. The holding is that although an application need not be deemed statutorily "complete" to trigger the protection of the Rule, the application must be submitted on the municipal application form with "all accompanying documents required by ordinance for approval," relying on the statutory definition of "application" under New Jersey law.

There has been a divergence of views on what constitutes an "application" for purposes of the Rule, ranging from a statutorily complete application to a minimalist filing. The trial court found that the application should have enough information so that a meaningful review could commence, however the Appellate Division did not agree. The opinion strikes a balance between the competing views, utilizing a clear statutory definition. Submission of the required documents is not the same thing as a complete application. As an example, a site plan could be submitted but not be complete because it is missing detail, such as topography.

What the opinion does not address is the treatment of requests for completion waivers, and their impact on the time of filing of the application for purposes of the Rule. If a waiver is sought, then all application documents will not have been submitted, so the Rule would not apply unless waivers are granted. This naturally leads to a possibility of litigation over the reasonableness of a denial of requests for completion waivers. Although not addressed in the opinion, it seems logical that the reversal of an unreasonably denied request for a waiver would result in the triggering of the Rule as of the filing date of the application. The opinion states that it is based upon common sense, however developers will need to carefully consider their strategy in the face of applications for controversial projects that may elicit a push for ordinance changes to adversely affect or deny them.

Many ordinances require the submission of reports such as traffic studies, environmental impact statements and drainage studies that require a long lead time for preparation. Developers typically ask for waivers for these items. However, in a complex application it is difficult to perceive a circumstance where a denial of a waiver request for such reports would be deemed unreasonable by a court. Accordingly, those types of reports should be confidentially initiated and prepared well in advance, so that when news of a pending application breaks, the filing requirements of the ordinance can be timely satisfied and the

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protection of the Rule invoked before a reactive ordinance is passed. The request for completion waivers will clearly put a project at risk of a successfully imposed change in zoning, site plan or subdivision ordinance.

Developers need to look carefully at the application requirements in the ordinance, including checklists and reports, early in the process and before going public with an application to understand what the submission requirements are in order to be prepared to obtain the protection of the Rule.

The *Dunbar* case has been appealed to the Supreme Court of New Jersey with certification granted July 20, 2017, and the appeal is pending. The outcome is worth watching, as the Court could move the application definition in a more or less restrictive direction.

Broker Who Procures Bona Fide Buyer Denied Commission Where Tenant Exercises Right of First Refusal

Barry S. Goodman

In a case the court called an "issue of first impression," the Appellate Division recently held that a real estate broker who procures a bona fide offer for the purchase of real estate is not entitled to a commission where the tenant then exercises its right of first refusal to purchase the property. The decision in *Pollack and SP Realty Advisors, LLC v. Quick Quality Restaurants, Inc.* raises serious issues for brokers who spend considerable time and energy procuring a buyer since they then may be denied a commission where a tenant exercises a right of first refusal basically on the same terms as the offer that was presented by the broker.

In *Pollack*, the owner had entered into a lease with Quick Quality Restaurants, Inc., at the Butler Plaza Shopping Center. The lease provided the tenant with a right of first refusal if the owner decided to sell the property.

Seth Pollack, a licensed real estate broker and principal of SP Realty Advisors, LLC, then spoke to the owner about selling Butler Plaza and the owner made it clear that, if Pollack found a buyer, any brokerage commission would have to be paid by the buyer. Pollack subsequently found a potential buyer, Levin Properties, LLC, and Pollack and Levin agreed that Levin would pay a commission of 1.5% of the purchase price. This was confirmed in an email. The owner and Levin entered into a sales contract for \$14.5 million that identified Pollack as the broker and provided that the buyer would pay the commission pursuant to a separate agreement. However, the tenant exercised its right of first refusal. Although the tenant, who in effect was stepping into the shoes of Levin, did not know who the broker was or the amount of the commission that the buyer was going to pay, the tenant was aware that a broker had procured the offer and was to be paid a commission by the buyer. Notwithstanding this knowledge, the sales contract between the owner and tenant was on the same terms as the Levin contract, except the tenant did not agree to pay the commission to Pollack.

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When the commission was not paid at the closing, Pollack sued. The trial court held that Pollack was not entitled to a commission and Pollack appealed.

The Appellate Division affirmed the trial court's finding, holding that, under these facts, there was no basis to require the tenant to pay a commission to Pollack. In so doing, the court rejected Pollack's arguments that he was a third-party beneficiary of the sales contract between the tenant and seller, Pollack had any basis to sue under the right of first refusal in the lease, there was any implied covenant of good faith and fair dealing between the tenant and Pollack, the statute of frauds had been satisfied, and Pollack was entitled to compensation under a theory of quantum meruit for the value of his services.

The court correctly noted that there are no published cases in New Jersey dealing with a brokerage commission in the context of the right of first refusal. However, it is interesting that the court did not analyze New Jersey case law where a broker who procures a tenant is being paid a commission as rent is paid but the property then is sold. In this scenario, the New Jersey Supreme Court has held that a buyer may be presumed to undertake the obligation to pay the broker's commission where the buyer was aware of the seller's duty to pay the commission.

Pollack has filed a petition with the New Jersey Supreme Court requesting that it overturn the Appellate Division's decision. Whether or not the Supreme Court agrees to hear this matter, brokers should be extremely careful about agreeing to find a buyer where the seller is not paying the commission and there is a right of first refusal that can be exercised by a tenant. In such a situation, it is recommended that there be a written agreement with the seller that the broker will be paid a commission regardless of whether or not the tenant exercises the right of first refusal. Otherwise, the broker's efforts to find a buyer may go uncompensated.

Turning Lemons Into Lemonade: Repurposing Struggling Properties to Create Value and Satisfy New Market Demands

Gary S. Forshner and **Matthew J. Schiller**

As New Jersey's economy, infrastructure and demographics continue to rapidly evolve, numerous commercial developments have recently become obsolete. Moreover, as one of the most developed states in the country, there are increasingly fewer "green" developable sites available in New Jersey. As a result, the state is littered with formerly thriving suburban office and retail properties – many in prime locations – that are vacant and perceived to be untenable in their current state. These "white elephant" sites, however, can present excellent repurposing or redevelopment opportunities, in light of the limited current supply of developable lands – and despite the record demand for multi-family, mixed-use projects, warehousing/distribution facilities, and modernized office buildings.

Over the past several years, many productive commercial developments have changed hands and/or have received necessary capital investments to remain thriving developments. Still, numerous outdated office and retail properties have been nearly abandoned, their owners unable to lease or sell them in their

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current condition, and perhaps lacking the vision or resources to reposition the property. As a result, these owners face a difficult economic quandary.

Struggling properties have historically been addressed by either (1) marketing them in their current condition until a new tenant/buyer is found, and thereafter improved based upon the tenant/buyer demands (this approach could either subject any future lease/sale to potential zoning contingencies and/or reduce the market rent/purchase price for the property), or (2) infusing significant cash, resources and time to modernize the asset on a speculative basis in order to make it more attractive for potential tenants/buyers (thus requiring substantial advances by the owner for the benefit of future tenants/buyers, whose preferences and timing are unknown). However, a third option, **repurposing and/or redeveloping the property for a different use**, has emerged as an increasingly viable alternative to the traditional approaches mentioned above, in keeping with recent market trends.

Repurposing a property can either partially or completely change the existing use onsite. Examples include converting former anchor boxes in a strip mall to warehouse distribution space, or to alternative entertainment uses such as restaurants, arcades, and movie theaters, or creating a mixed-use center onsite. Similarly, vacant office properties can be repurposed for higher demand uses such as multi-family apartments, warehouses, hotels and other mixed-use developments onsite. Although repurposing may significantly increase the value of a property, it often involves entirely different uses than what currently exist onsite, thus requiring potentially significant zoning approvals to effectuate the plans for the property. More municipalities are working with developers to reposition properties because they recognize that “white elephants” may be repurposed in a variety of ways to align with community interests.

New Jersey law affords many zoning tools for owners to repurpose properties. The Municipal Land Use Law (MLUL) offers traditional zoning protocols, such as site plan approvals, use and bulk variance relief and rezoning, to permit alternative uses to be developed onsite. However, the likelihood of success using traditional zoning methods for new uses is often contingent upon whether a proposed use is “as of right” under the applicable zoning code or whether the variance relief can be justified. Use variance relief, in particular, is highly difficult to justify under the MLUL. As a result, there is a substantially heightened risk that an objector could successfully challenge an approval and/or the grant of use variance relief. In selective cases, the MLUL is a terrific tool for the repurposing, but the law provides additional tools to accomplish that objective.

New Jersey’s Local Redevelopment and Housing Law (LRHL) can be the critical statutory tool to enable struggling properties to be repurposed. Indeed, the LRHL lends itself best to form-based zoning and mixed use projects as opposed to the traditional “Euclidean zoning” that exists in most municipalities under the MLUL. The LRHL provides protocols and statutory criteria for a property to be designated as an “area in need of redevelopment”, thus permitting the municipality to amend its ordinance and make the proposed use “as of right” onsite. Under the LRHL, a property may qualify as “an area in need of redevelopment” upon “the discontinuance of the use of buildings previously used for commercial, manufacturing, or industrial purposes.”

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Accordingly, even if a property is in good condition, if it has been vacant for a considerable period of time (e.g., an office building or retail site has been vacant for multiple years), this fact could be a sufficient stand-alone statutory basis to qualify the property as a redevelopment site under New Jersey law. Alternatively, if the site is adjacent to an existing redevelopment area, a property owner could seek to be incorporated into the existing redevelopment plan. In either instance, a property can utilize New Jersey's redevelopment designation process to permit creative or mixed use projects to be developed "as of right", circumventing the need for legally challenging use variance relief under the MLUL. Moreover LHRL projects designated as areas in need of redevelopment qualify for various economic incentives – potentially making an otherwise financially challenging project economically feasible. One of the more notable and common examples is the eligibility of LHRL projects to qualify for the payment in lieu of taxes (PILOT) program, which could substantially reduce the development's property tax obligations upon completion.

Several steps must be undertaken by the municipality under the LHRL in order for a property to be designated as an "area in need of redevelopment," but the numerous benefits and opportunities presented by this designation can result in a successful project, one that was otherwise potentially insurmountable. First, the municipality's Council must adopt a resolution directing the Planning Board to conduct a preliminary investigation as to whether the site qualifies as an "area in need of redevelopment." Then, the Planning Board must commission a preliminary investigation report, conduct a public hearing concerning the potential redevelopment designation, and make recommendations to the Council on whether to include/designate the site as an "area in need of redevelopment." Upon receipt of the Planning Board's recommendation, the Council must then adopt a resolution declaring the site as an "area in need of redevelopment" and prepare and approve a redevelopment plan delineating the new permitted uses and other new zoning requirements for the site. Upon the completion of the redevelopment plan, the Council would adopt the redevelopment plan by Ordinance and make the proposed redevelopment/repurposing of the subject property an "as of right" development, subject to receipt of site plan approvals by the Planning Board.

Owners of struggling commercial properties face many economic hurdles to revitalize their investments. Repurposing commercial properties utilizing the methodology and procedures set forth in the LHRL can afford property owners a more certain path towards achieving their redevelopment plans. However, navigating through the various statutory requirements to obtain the redevelopment designation can be quite challenging. It is critical to assemble an advisory team that includes land use and real estate attorneys with significant zoning, leasing and transactional experience who can assist in the evaluation of properties and address any issues that arise on the road to enhancing the viability and marketability of properties in 2018 and beyond.