

2015 Real Estate Update: Trending Issues & Topics of Interest

Real Estate Department

Greenbaum, Rowe, Smith & Davis LLP Client Alert

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As we settle into the new year, the members of our Real Estate Department have taken stock of what's on the horizon and/or top-of-mind in their respective areas of focus. The emphasis is on potential impacts for the firm's clients, along with the "big picture" influence of certain developments on New Jersey's commercial real estate sector at large.

We are also delighted to welcome two new partners to our Real Estate practice, Lydia C. Stefanowicz and Matthew J. Schiller. Both made important contributions to this Update, and we're excited to have them join our ranks.

All best wishes for a healthy and successful 2015!

The State of New Jersey's Industrial Market

Author: Jack Fersko, Department Co-Chair

We anticipate continued growth within New Jersey's industrial real estate market in 2015, with a number of key factors expected to play a part in the economic well-being of the state's industrial market. The expansion of the Panama Canal and raising of the Bayonne Bridge have already influenced demand, as does the continued growth of e-commerce combined with New Jersey's proximity to the most densely populated areas of the country.

The ongoing expansion of the e-commerce industry can likely be attributed to a number of factors. Millennials continue to rent due to higher education loan debt and resulting difficulties in amassing sufficient equity to purchase. This makes storage space an ongoing challenge, which when combined with increasing demands of work and child rearing, results in more online purchasing of everyday basics and demand for same day or next day delivery. As such, the demand for warehouse space continues to expand, a trend we anticipate will stay the

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course as the year progresses.

Perspective on Real Estate Tax Appeals in 2015

Author: Thomas J. Denitzio, Jr., Department Co-Chair

The pressure to assess taxable real estate to finance municipal government has never been greater. The massive reduction in the market value of real estate over the last several years has created a tension between public officials and taxpayers, in particular the owners of commercial and industrial real estate. This conflict has been somewhat resolved by proactive communities, on the one hand, and owners who have already filed assessment challenges, on the other. However, opportunities to lower real estate taxes, a significant operating expense, remain.

We foresee that the volume of tax appeals will remain high, especially in those towns that have not recognized the realities of the current market. We routinely review, at no cost to our clients, the real estate tax assessment of their property to determine whether an appeal is warranted. This year's appeal filing deadline is April 1, except in those towns that revalue or reassess, in which case the filing deadline is May 1.

Analysis of the Commercial Real Estate Debt Market

Authors: Lydia C. Stefanowicz and Charles Wilkes

The commercial real estate debt market is likely to stay strong in 2015. For recognized sponsors and quality properties, there is more capital available than there are borrowing needs. Bidding wars among lenders, already common in 2014, can be expected to accelerate. While at this time there remains considerable discipline in the market in terms of LTV ratios and reserve requirements for quality credits, profit margins for lenders are razor thin and shrinking. Query if this is the year that CRE lenders (at least the unregulated ones) become too aggressive and ignore the lessons of the pre-2008 markets?

CRE lenders, large and small, are flush with capital to deploy. Banks have largely completed their post-financial crisis deleveraging and the restructuring of risky loans made in the overheated market of the mid-2000s. Investment banks have returned to debt securitization, and CMBS lending is growing again. Life insurers, the most steady and disciplined of CRE lenders, continue to finance high quality projects and are projected to moderately increase their total lending in 2015. Total CRE loan volume is widely expected to rise in the coming year.

A series of macroeconomic factors provides the foundation for this lending rebound. Global economic headwinds, historically low interest rates, demographic trends and a growing U.S. economy are likely to keep the real estate debt spigots open. At the same time, slowing growth in emerging markets and turmoil in European markets are driving foreign capital into the United States and keeping domestic capital at home. Record low returns on safe-haven U.S. Treasuries have investors searching for yield in real estate debt, which offers an attractive risk/reward proposition relative to other asset classes at this time. In New Jersey, new construction is presenting opportunities to lend, particularly in the cases of premium multi-family residential projects designed to appeal to urban-dwelling millennials and empty-nesters, as well as

industrial warehouse space to support the growing online economy and anticipated expansion of traffic at Port Newark and Port Elizabeth. Together, these factors are attracting capital into commercial real estate and will likely keep the real estate debt markets active, and competitive, in 2015.

Making Headlines: Ongoing Scrutiny of Lenders and Service Providers

Author: Matthew J. Schiller

State and federal agencies continue to pursue enforcement actions to address perceived causes of the recent recession. After the market collapsed, the Financial Crisis Inquiry Commission determined that ratings agencies such as Standard & Poor's, Moody's and Fitch were a "key cause" of the crisis. Although rating agency opinions are purportedly independent, objective, and free of outside influences, they are paid for by the issuers of mortgage-backed securities and constitute a significant revenue source for the companies. Federal and state authorities have alleged the use of "issuer friendly" analytical models and insufficient monitoring efforts by rating agencies. Rating agencies countered that they merely offer opinions, and that those opinions are protected speech under the First Amendment, similar to newspaper editorials; however, such argument has been repeatedly defeated throughout the country in recent federal and state court decisions.

Standard & Poor's recently agreed to a global \$1.375 billion settlement to resolve certain actions brought by the U.S. Justice Department, New Jersey, 18 other states, and the District of Columbia with respect to its practices. New Jersey will receive \$21.5 million from the settlement proceeds. Prior to the settlement, the State of New Jersey alleged violations under the New Jersey Consumer Fraud Act, N.J.S.A. 56:8-1 to -195, (the "CFA") against S&P and its parent company, McGraw-Hill Financial Services, LLC, in the matter *John J. Hoffman, Acting Attorney General of the State of New Jersey, and Steve C. Lee, Acting Director of the New Jersey Division of Consumer Affairs, v. McGraw-Hill Financial, Inc. and Standard and Poor's Financial Services, LLC*, (Docket No. ESX-C-216-13). On December 31, 2014, the court denied S&P's motion to dismiss, concluding that it had jurisdiction over New Jersey's CFA claims as they neither involved actual securities nor violated the Constitution of the United States. Had the case been dismissed, New Jersey's participation in the recent settlement would have been significantly jeopardized.

This litigation is just one example of the constantly evolving regulatory and litigation landscape confronting the lending industry and its service providers. The firm will continue to monitor state and federal legislation and local and national case law in order to proactively protect and address our clients' needs.

Condominium Conversions in Non-Residential Settings

Author: Christine F. Li

Condominium structuring and formation are frequently being used as tools in commercial, business, industrial, parking garage, and mixed use developments. Although condominium ownership is most commonly recognized in the residential context, the advantages of condominium conversions have made them popular in the ownership and financing of non-residential and mixed-use real estate developments.

Published Articles (Cont.)

Large-scale sites and structures which had previously been used as industrial, manufacturing, or casino facilities are being rehabilitated and repurposed as condominiums to allow for the separate ownership and financing of individual units. This scenario affords unit owners the ability to qualify for financial incentives for the rehabilitation of specific areas. For unimproved lands, the creation of "land units" gives the respective owners of the land parcels rights to develop the lands in the future as though they were legally subdivided parcels of land.

The creation of a condominium will result in the separate taxation of the units. Municipal tax assessors are obligated under the New Jersey Condominium Act to identify each unit in a condominium by a separate tax lot and block reference and to issue a separate tax bill for each unit. Common areas and amenities may also be legally and permanently dedicated for the use of certain owners, to the exclusion of others. The master deed creating the condominium will also allocate the interests in the condominium among the owners, and the liability for the cost of the maintenance, repair and replacement of the improvements within the condominium.

Environmental Insurance Reemerges As Important Risk Management Tool

Author: Ann M. Waeger

We are observing a strong resurgence in the use of pollution liability insurance to manage environmental risks in a transactional setting. These risks include the discovery of unknown environmental contamination during the course of development that requires cleanup; changes in cleanup standards for contamination left in place on a property which results in the need for further investigation or cleanup; and bodily injury or property damage claims related to contamination at a property. The drivers behind this resurgence include a return to residential development in New Jersey, as well as the strong industrial real estate market throughout the state.

On the business end, there continues to be significant competition in the environmental insurance marketplace. Presently, there are approximately forty insurance companies globally writing some type of environmental insurance coverage. As a result, premium pricing is much better than a few years back, and insurers appear more willing to negotiate policy terms to afford better coverage.

One negative development in the market is that AIG, a significant market player, has pulled back on the issuance of policies with 10 year terms. The maximum term for its policies is now 5 years. This was a surprise to many, especially given the strong demand for 10 year terms in the transactional setting. The good news, however, is that there are still major insurers (Zurich, XL, ACE and Chubb), as well as new players (including Beazley and Great American), who are willing to issue 10 year policies under the right circumstances.

Overview of NJ's New Complex Business Litigation Program

Author: Steven Firkser

As of January 1, 2015, the New Jersey state courts have implemented a Complex Business Litigation Program that will apply to complex commercial, real estate and construction litigation. The program is

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designed to address the needs of the business community by streamlining the litigation process.

Each county has been assigned a designated Complex Business Litigation Judge who is highly experienced and knowledgeable, and who will also receive extensive specialized training in all areas relating to business litigation. Each designated judge will be expected to issue at least two written opinions per year in order to develop a body of case law on issues relating to business litigation.

Eligible cases will generally involve amounts at issue exceeding \$200,000, complex factual or legal issues, large numbers of parties, witnesses, and/or documents, and substantial time required for trial. Complex commercial cases will involve complex business and commercial issues, and complex construction cases will involve construction projects and issues among owners, contractors, architects, engineers, and design and construction consultants. The program does not include matters primarily involving consumers, labor organizations, personal injury or condemnation cases, or cases in which the government is a party.

County assignment judges will review and monitor cases to determine if they are appropriate for the program, and parties may seek to be included in the program or removed if they assert the action does not meet eligibility criteria. The cases will be closely managed by the designated judges in an effort to expedite resolution or trial. We expect that this new program will prove beneficial to business entities litigating matters in the New Jersey courts.

Liquor License Reform Is On The Horizon

Author: Anthony Giountikos

The purchase of an ongoing New Jersey restaurant business is a challenging undertaking, particularly if the establishment sells liquor pursuant to a liquor license that must be transferred before a closing. Unlike typical legal issues such as contract formation, due diligence, lease assignment, adjustment of inventory and covenants not to compete, the transfer of a liquor license is a complicated and time-consuming process that usually takes 90 to 120 days to complete. The process includes the completion and filing of the standard 12 page New Jersey Division of Alcoholic Beverage Control application, fingerprinting and police background investigations of the principals that comprise the purchasing entity, issuance of a tax clearance by the New Jersey Division of Taxation, publication of the proposed liquor license transfer in an approved local newspaper and formal approval of the transfer by resolution from the issuing municipality where the liquor license is located.

Further complicating the current New Jersey liquor license legal landscape is the controversial issue of liquor license reform, which seeks to create new affordable classes of liquor licenses that will promote redevelopment efforts throughout the state. The introduction of liquor license reform legislation in the Assembly is expected in early 2015. If you are considering the prospect of purchasing and operating a restaurant, or establishing a new restaurant in a redevelopment district, this is an important issue to consider in your overall planning strategy.

Are Commercial Tenants Still Exercising Lease Renewal Options?

Author: Steven C. Delinko

With the exception of those who were fortunate enough to have previously negotiated a favorable renewal rate in their commercial leases, commercial tenants are in general opting not to exercise existing renewal options - where the renewal rate is tagged to fair market value or some percentage thereof - and are instead electing to negotiate extension terms. This trend first gained traction several years ago, as a result of the recession, and continues to date.

Commercial tenants, understandably and prudently, are reviewing their leases considerably in advance of the term expiration, using the opportunity to renegotiate the entire lease document. Property owners, as a result of a surplus of commercial space in the market, are open to negotiating terms and especially concessions, improvement allowances and the like, in exchange for increased tenancy terms. The extended term income streams allow the property owners to refinance in an attractive lending climate. All in all, we believe this to be a "win-win" situation for both landlords and tenants.

Caution to tenants is still advised in retaining the renewal option during the extension term. These options are very valuable as they unilaterally permit the tenant to remain in the space pursuant to their terms, as opposed to extension agreements which, by definition, require agreement between landlord and tenant.

Notification Requirements For Purchase of Business Assets Are Broad Based

Author: Regina E. Schneller

All parties involved in the so-called "bulk transfer" purchase of business assets in New Jersey must notify the Division of Taxation at least ten business days before the impending sale, transfer or conveyance of those assets, except in cases where the purchase takes place within the ordinary course of business. This notification must be provided by submitting Department of Treasury Form C-9600 via registered or certified mail or overnight delivery.

The term "business" is broadly defined as "any endeavor from which revenue or consideration is realized for the purpose of generating a profit or loss." A similarly broad definition of "business assets" encompasses both tangible assets and intangible assets, and includes real estate holdings including vacant land, as well as "goodwill, materials, supplies, licenses, patents, copyrights, equipment, leases, merchandise or other inventory."

Within ten business days of receiving notice, the Division of Taxation will advise the purchaser whether an escrow will be withheld from the seller's closing proceeds to secure payment of the seller's tax liabilities. Failure to provide appropriate notice may result in the purchaser being personally liable for all of the unpaid taxes of the seller. Even if the seller is a tax exempt entity notice must nonetheless be provided, as a tax exempt entity may still have tax obligations, including sales tax obligations.

Published Articles (Cont.)

We routinely advise clients, especially in instances where the purchaser is not certain if a particular transaction is subject to the notification requirements, to file notice within the appropriate time period in order to avoid potential adverse economic consequences. In our experience, taking this precautionary measure is the prudent course of action.

Recent Case Law On Arbitration Clauses in Construction Contracts

Author: Kenneth T. Bills and John H. Hague

Construction contracts often include arbitration clauses with the expectation that any disputes will be resolved more quickly and inexpensively than through traditional litigation. A pair of recent opinions, however, brings into question the enforceability of many commonly used arbitration clauses, at least in consumer contracts.

In *Atalese v. U.S. Legal Service Group*, the plaintiff was contesting the enforceability of an arbitration clause in a contract for debt-adjustment services, while in *Dispenziere v. Kushner Companies*, the plaintiffs were homebuyers who objected to enforcement of the arbitration provision in their purchase agreements. In each instance, the court refused to require the plaintiffs to arbitrate on the grounds that the arbitration clause did not clearly state that the parties were waiving the right to proceed to sue in court.

Even though the arbitration clause in *Atalese*, for example, contained mandatory language ("In the event of any claim or dispute...the claim shall be submitted to binding arbitration") and stated that "[a]ny decision of the arbitrator shall be final", the New Jersey Supreme Court found that the clause lacked "any language ...that plaintiff was waiving her statutory right to seek relief in a court of law." Waivers of important rights must be knowing and the language of the contract provision must express that knowledge. There is also a requirement that consumer contracts be in plain language. In each of these cases, the courts found that the consumer parties could not have been fully informed that they were waiving their rights to go to court, and also noted the overall length of the contracts and absence of anything to draw the consumer's attention to the arbitration provision.

These decisions have obvious implications for construction contracts with consumers. Most importantly, arbitration provisions should clearly state that the parties are agreeing to arbitration and waiving any statutory or other right to sue in court or avail themselves of other dispute resolution processes, and not just provide for final and binding arbitration. It may also be prudent to format the arbitration provision in a manner that makes it prominent in the contract. Where there are statutory rights to sue in court, it will also be prudent to provide for an express waiver.

Because the principle that waivers of important rights must be clear and unmistakable is not limited to consumer contracts, these decisions may also have implications for commercial arbitration provisions as well, and contractors are therefore cautioned to closely review the arbitration clauses in all contracts.

NJ's Revised Uniform LLC Act Impacts Real Estate Holding Companies

Published Articles (Cont.)

Author: Senwan H. Akhtar

New Jersey's Revised Uniform Limited Liability Company Act, which replaced the state's original Limited Liability Act last year, represents a significant development for New Jersey limited liability companies that act as real estate holding companies. It is therefore important for those entities to understand the rights and responsibilities that they have under the revised Act with respect to each other and third parties.

Investors and entrepreneurs may enter into real estate joint ventures with family members or friends without written operating agreements, under the assumption that they will cooperate amicably in the management of the company. Although the revised Act recognizes the validity of verbal operating agreements based on the manner in which members have been operating a company, we strongly counsel clients to enter into written operating agreements so that the rights and obligations of the members are clear. Without a verbal or written operating agreement, the new default rules of the revised Act will apply to the members' relationships with each other. These rules may impact members' rights relating to voting, distributions, management, fiduciary duties, exculpation, indemnification, minority oppression, conversion and domestication.

Members of real estate holding companies are urged to think carefully about each of these provisions and enter into written operating agreements that address their particular needs. With respect to limited liability company members who are parties to written operating agreements that pre-date the revised Act, we recommend that those agreements be reviewed to determine whether they should be updated in light of the provisions of the revised Act.

An Update on NJ's Retail Marketplace

Author: Hal W. Mandel

After a long drought caused by the recent recession, the retail leasing market is becoming a more level playing field. While, as is always the case, different areas of New Jersey have recovered sooner and stronger than others, vacancy factors in traditionally strong areas of the state have decreased to levels not seen in six or seven years. For example, the retail vacancy rate along central New Jersey's major shopping corridors at the end of 2014 was 7.6%, compared to a high of 10.5% in 2011 and a low of 3.4% in 2006.

In addition to location, the vacancy rate is substantially different depending on the types of properties. In general, smaller retail spaces seem to have recovered better than larger spaces, with the vacancy rate for "big box" locations, for the most part, still at a higher rate than the vacancy rate for smaller stores.

There are many factors that are currently affecting the retail marketplace - some favoring landlords of certain properties and some favoring tenants. Changes in the marketplace have occurred as a result of the continued and growing emphasis on e-commerce. On the one hand, this is resulting in a decrease in the size of many of the "big box" retailers, while at the same time, certain e-commerce retailers are beginning to open up brick and mortar locations to better service their customers.

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While one would expect that the historically low interest rates would open the doors for new businesses needing new locations, bank loans to smaller retailers continue to remain difficult to obtain.

The marketplace in traditionally strong market areas is beginning to lean in favor of landlords, however there is still opportunity for tenants to negotiate provisions in their leases that were previously non-negotiable, while at the same time, with a little flexibility, permitting landlords to continue to obtain full or nearly full occupancy. For example, whereas before the recession landlords were fairly insistent on obtaining personal guaranties for non-credit tenants, tenants may now have some leeway, while at the same time still providing landlords with sufficient protections. This may be accomplished by either limiting the dollar amount of tenants' personal guarantees, reducing the length of the guaranty to the early years of a lease when the tenant is more likely to be at risk, or providing a so-called "good guy" guaranty - guaranteeing that if the location ends up not being a viable one for the tenant, the tenant will provide the landlord with some prior agreed-to advance notice (usually one year) of the tenant's intent to terminate the lease provided that no event of default occurs during that one year time period. During the one year time period, the landlord has the ability to mitigate its damages by finding another tenant for the space.

Additionally, because of continued tight credit, tenants may need and be able to obtain lower security deposits than previously required by landlords. Tenants may also seek favorable rent abatements at the beginning of a lease or perhaps additional amounts of landlord-provided leasehold improvements.

Until the retail market further settles into normalcy, the key to success for both landlords and tenants is to be flexible and attempt to address each other's needs.