2016 Real Estate Update: Trending Issues & Topics of Interest

Real Estate Department

Greenbaum, Rowe, Smith & Davis LLP Client Alert

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In the world of commercial real estate, it's hard to overstate the importance of making critical business decisions from the vantage point of being well-informed about market and economic trends, legislative and regulatory developments, best practices and other issues that drive the industry.

This publication provides the perspective of our Real Estate Department on a number of important topics that fall within the scope of our practice, including potential impacts on our clients' business interests here in New Jersey.

We hope you find our insights both relevant and valuable.

Attorneys

Kenneth T. Bills
Thomas J. Denitzio, Jr.
Martin E. Dollinger
Jack Fersko
Steven Firkser
Christine F. Li
Steven G. Mlenak
Regina E. Schneller
Lydia C. Stefanowicz
Ann M. Waeger

As Industrial Market Continues to Stabilize, Ground Leases Offer an Excellent Option for Property Owners

Jack Fersko, Department Co-Chair

The enthusiasm for the industrial market continued throughout 2015, fueled by a number of factors, including the continued growth of the e-commerce industry and of urban centers. These elements resulted in sustained and increasing demand for warehouse space in close proximity to urban environments, which in turn yielded both speculative development of warehouse space and foreign investment in the industrial market. As NAIOP's *Development Magazine* reported in its Winter 2015/2016 edition, quoting Starbucks CEO Howard Schultz, "... the Internet as we know it today is literally the death of distance."

A phenomenon of particular interest in 2015, which is continuing into 2016, is the growth of the ground lease in the industrial market. The ground lease is a common vehicle for real estate transfers in New York

City and other large urban locals. However, it has traditionally been a far less commonly-used technique here in New Jersey, particularly in the industrial setting.

The ground lease offers an entrepreneurial property owner the opportunity to maintain a real estate portfolio without the burden of day-to-day management responsibilities and intensive capital investment. This structure also enables the entrepreneurial real estate family the facility for continued real estate ownership, even in a setting in which the "next generation" does not join the family business.

Although a ground lease can be a terrific device for maintaining ownership and passing ownership along to the next generation, there are a number of critical issues that must be addressed properly in order to protect the investment. These include avoiding a subordination of the fee interest, properly addressing subordination of the fee mortgage, rights to and use of proceeds in a casualty and condemnation, leasehold mortgagee recognition, leasehold mortgagee rights to a new lease following a lease termination, sublease and assignment rights prior to stabilization, and more. The benefits to a property owner can be excellent, however careful analysis is critical to avoid the many potential pitfalls that abound in a ground lease transaction.

Letters of Intent: To Sign or Not to Sign?

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

"Don't sign anything unless I review it first."

This is excellent advice from any real estate attorney to a client in order to avoid unintended consequences. A recent decision from the New Jersey Superior Court Appellate Division proves the point.

In *Trend Investments v. Surjit Enterprises*, the owner of a strip mall that was listed for sale met with one of his tenants. The tenant verbally offered to buy the property and the owner accepted. To memorialize their agreement, they then handwrote and signed a document that recited their names, identified the property, and specified the purchase price and required deposit.

Several weeks later, the owner received an offer from a third party to purchase the property at a higher price. After the owner called his tenant to inform him that he was cancelling their agreement and selling the property to a different buyer, the tenant sued to enforce the agreement. The trial court entered judgment in favor of the tenant/buyer.

The owner's appeal was denied. The Appellate Division held: "A signed memorandum, even if preliminary in nature, is sufficient to bind the signatories of the memorandum if such is their intent."

There are many other situations where courts have enforced letters of intent against the parties, even though they were not "formal" contracts and did not incorporate all terms of the deal. This usually occurs in instances where the parties' intent that the letter not be enforced is either absent or is expressed

inadequately.

Whether drawn by a lawyer or handwritten on a napkin, we always caution our clients to provide us with the opportunity to first review what they are asked to sign where it impacts, in any way, their use or ownership of real estate. This has become, and will continue to be essential in an increasingly complex legal environment.

Exemptions from Registration Requirements Under NJ's Planned Real Estate Development Full Disclosure Act

Christine F. Li, Partner

Commercial and residential property owners and developers often approach potential developments subject to condominium ownership or administration by a community association with reluctance. Subjecting property (improved or unimproved) and offering interests in planned developments for sale raises the specter of registration and regulatory compliance under New Jersey's Planned Real Estate Development Full Disclosure Act. The New Jersey Department of Community Affairs (DCA) is the agency responsible for administering registration and other compliance obligations.

The owner or developer of a development subject to the Act is required to submit an application for registration to the DCA, and obtain an order registering the development, before offering or disposing any interests in the development. The preparation and registration of a public offering statement (POS) is part of the application process and is subject to the agency's scrutiny. Offering is broadly defined as "any inducement, solicitation, advertisement, or attempt to encourage a person to acquire a lot, parcel, unit or interests in a planned real estate development." The disposition of interests subject to the Act encompasses "any sales, contract, lease, assignment, or other transaction concerning a planned real estate development."

Registering a development is a costly endeavor, requiring the services of accountants, property managers, surveyors, engineers and architects, as well as an attorney. It is also a time consuming process, as it typically takes months to complete the application and see it through the review process at DCA. The entire process is a hurdle which must be scaled prior to the construction of the development and the commencement of marketing and sales efforts. Until the registration process is completed, the owner or developer cannot sell or otherwise offer any of the interests in the development. Once registered, the development is subject to the DCA's continual oversight, along with the citation of violations and the imposition of penalties and fines, until such time as the agency issues an order terminating the developer's responsibility under the Act.

There are, however, certain exemptions from registration under the Act, and in evaluating a proposed development it should not automatically be assumed that the requirements of the Act will be applicable. Some developments are exempt by definition, while other exemptions require the submission of an

application to the DCA. The most common "automatic" exemptions are subdivided lot developments, sometimes referred to as "fee simple" communities of less than 100 lots. Developments where the common elements are limited to the provision of unimproved, unencumbered open space are also exempt, as are developments wholly for industrial, commercial or other nonresidential purposes, or those where the development is composed wholly of rental units.

Exemptions commonly requested and granted by the DCA are in the context of condominium developments of fewer than 10 units, or where the offering consists entirely of units affordable to persons of low or moderate income, as defined in the regulations. In instances where the agency "otherwise finds that the enforcement of the Act is not necessary in the public interest or for the protection of purchasers by reason of the small amount of the purchase price, or the limited character of the offering, or the limited nature of the common or shared elements" the DCA has broad discretion to grant an exemption to the registration requirement. In those instances where the agency deems a development to be exempt from registration requirements, the developer will be required to make a limited disclosure of key information about the developer and the operation of the development.

Familiarity with the exemptions under the Act may very well eliminate a costly and time-consuming obstacle when conducting the due diligence for the acquisition of a project or planning the construction of a development.

Achieving Tax Savings: The Grow New Jersey Assistance Program

Matthew J. Schiller, Partner

Businesses, landlords and prospective tenants should be aware of the potentially significant economic benefits available through the Grow New Jersey Assistance Program (Grow NJ).

Administered by the New Jersey Economic Development Authority (NJEDA), Grow NJ provides tax credits ranging from $500 per job, per year to $2,000 per job, per year to qualified businesses that make, acquire or lease qualified capital investments in facilities that will either create or preserve jobs in the numerous qualified incentive areas within the state. Accordingly, Grow NJ constitutes a valuable economic tool for businesses looking to move to or stay in New Jersey, and for landlords looking to attract new tenants to qualified properties.

There are a wide range of "qualified incentive areas" under the Grow NJ program. Locations include distressed municipalities; Garden State Growth Zones (Atlantic City, Camden, Passaic, Paterson, or Trenton); urban transit hubs; areas designated as being in need of redevelopment within Atlantic, Burlington, Camden, Cape May, Cumberland, Ocean or Salem counties; Port districts; certain "Priority Areas" such as those designated under the State Planning Act as Planning Area 1 (Metropolitan), Planning Area 2 (Suburban), Planning Area 3 (Fringe Planning Areas); disaster recovery projects; qualified incubator facilities; highlands development credit receiving areas or redevelopment areas; tourism destination

projects; transit-orientated developments; and vacant commercial buildings having over 400,000 square feet of office, laboratory or industrial space available for occupancy for over a period of one year.

Qualified incentive areas also include any land located within a smart growth area and planning area designated in the Meadowlands District Master Plan or owned by the New Jersey Sports and Exposition Authority. Even qualified properties located in Planning Area 4A (Rural Planning Area), Planning Area 4B (Rural/Environmentally Sensitive) and Planning Area 5 (Environmentally Sensitive) such as designated centers and areas in need of redevelopment may be eligible for certain tax credits under the Grow NJ program.

To be eligible for Grow NJ tax credits, the business must make, acquire, or lease a capital investment at a qualified business facility that will retain and/or create a certain number of full time jobs, and be constructed in accordance with established environmental and sustainability standards; provided that there is a net positive benefit to the State of New Jersey of at least 110% of the requested tax credit allocation during the first 20 years of the project, and provided that the award of the tax credits is a material factor in a business's decision to create/retain such jobs.

Capital investments can include site preparation and construction, repairs, renovations, and improvements on real property, and/or obtaining and installing furnishings and machinery, apparatus, or equipment, including material goods subject to bonus depreciation under Sections 168 and 179 of the Internal Revenue Code for the operation of the business.

Grow NJ tax incentives vary greatly depending on the location and/or type of the qualified business facility and number of jobs to be created and/or retained. In order to qualify, applications must be submitted to the NJEDA and numerous lease requirements must be satisfied, including but not limited to satisfying certain affirmative action, prevailing wage, and green building requirements.

Our firm works with businesses and landlords to identify what properties are potentially eligible for Grow NJ incentives, and assists them in navigating through the numerous ownership, leasing, construction, and operational issues that must be managed in order to maximize their investments.

The Importance of a Survey in Commercial Real Estate Transactions

Anthony Giountikos, Counsel
Regina E. Schneller, Partner

The purchase of commercial real estate should entail a careful investigation of various aspects of the property being considered. In addition to contractual due diligence in the form of seller representations and warranties, an independent investigation conducted by qualified professionals is necessary to determine the physical condition and legal status of the property.

An important component of the investigation is the procurement of a commitment from a title company to issue title insurance. Invariably, the title commitment contains exceptions to coverage including, without limitation, a general exception for conditions that may be disclosed by a current and accurate survey of the property.

To remove the general survey exception from the title commitment, the title company will typically require a current ALTA survey where commercial real estate is involved. Such a survey is prepared by a licensed surveyor in accordance with standards established by the American Land Title Association and the American Congress of Surveying and Mapping. Most importantly, the ALTA survey depicts the boundary lines, all improvements, encroachments and easements, the ingress and egress access to public rights of way, and a table with the zoning requirements applicable to the property.

Besides the need to satisfy the requirements of the title insurer (and possibly a lender), thepurchase of an ALTA survey is highly recommended to protect the interests of a buyer of commercial real estate. Boundary line disputes, encroachments by existing improvements, and zoning violations exist more often than one would expect. Such conditions may substantially compromise the value and use of the property and can be avoided by obtaining an accurate up-to-date ALTA survey.

Non-Recourse Loans: A Dangerous Misnomer

Lydia C. Stefanowicz, Partner

Historically, in the context of commercial real estate mortgage loans, a non-recourse loan was one where the lender agreed to look solely to the mortgaged property for repayment of the loan in the event of a default. It was a simple concept; no exceptions. However, although the designation "non-recourse" continues to be used widely, truly non-recourse commercial mortgage loans have not been seen since about the early 1980's.

Over time, exceptions - recourse carve outs - have developed, as a result of which the borrower and guarantors incur personal liability. The ability of borrowers and guarantors to limit their personal liability in connection with a commercial real estate mortgage loan has been increasingly diminished to the point that today, describing some of these loans as non-recourse is a misnomer.

The recourse carve outs are of two types, differentiated by their consequences. First, there are the events that give rise to personal liability on the part of the borrower and guarantors for actual damages suffered by the lender as result thereof, but still impose no liability for the debt. Second, there are the events that trigger full recourse personal liability for the debt on the part of the borrower and guarantors.

Not only has the list of recourse carve outs grown over the years, but the traditional recourse carve outs have been expanded as well, further broadening the liability of borrowers and guarantors. In addition, the triggering events are more likely now to create full recourse personal liability for the entire indebtedness rather than only for lender's damages. Since borrowers are typically single asset entities, it is guarantors

that bear the economic risk of triggering a recourse carve out.

Recent court decisions have repeatedly asserted that commercial borrowers and guarantors are sophisticated parties, represented by counsel, who presumably understood the loan documents and agreed to them, and thus should be bound by their literal terms. As a result, most courts have strictly enforced the recourse carve out provisions, and when they are vague have most often interpreted them in the lender's favor.

So what can borrowers and guarantors do in today's non-recourse loan market to understand and limit their potential liability?

First, a borrower should not assume that there exists a standard list of recourse carve outs that every non-recourse lender subscribes to. In fact, there is a great deal of variety in both the types of events that give rise to personal liability and the scope of those triggering events. In addition, there are differences from lender to lender as to which recourse events trigger full liability for the debt or merely liability for damages suffered by the lender.

Second, a borrower should not leave the recourse carve outs to be negotiated for the first time when drafts of loan documents are distributed. A borrower should insist on reviewing and negotiating the recourse carve outs before it has put any money at risk in the form of deposits or escrows. Once the borrower has accepted a term sheet, the deal takes on momentum and it becomes difficult to walk away from the loan in light of the money that has been put at risk and the transaction costs that have been already incurred.

Third, the precise wording of each recourse carve out should be scrutinized carefully. A recourse carve out for any event can be drafted narrowly or expansively. It can be vague and ambiguous, or it can identify clearly the specific actions that will trigger personal liability. The extent of the personal liability arising from a recourse carve out event can be for lender's damages or for the entire indebtedness. Ideally, the extent of the liability of the recourse parties should match the magnitude of the consequences to lender of a triggering event.

Finally, a borrower, with the assistance of knowledgeable counsel, needs to carefully review and assess each and every representation and warranty and each covenant to avoid unintended or unanticipated consequences arising from seemingly immaterial breaches of their terms. Based on recent court decisions, a borrower should not expect that it will have either the right or the opportunity to cure a seemingly inconsequential "technical breach" of a representation or warranty, or of a covenant that also gives rise to a recourse carve out. "Technical breach" is an argument made by a borrower or guarantor after the fact; it will likely not be the guiding legal principle by which a court decides recourse liability in the context of a commercial real estate loan.

Commercial Real Estate Debt Markets in 2016: Modest Growth, Fierce Competition and Regulatory Pressures Expected

Charles J. Wilkes, Associate

With several years of steady growth in the rear-view mirror, interest rate hikes and global economic headwinds on the horizon and increased regulatory scrutiny on many lenders' minds, will the real estate debt markets experience another year of growth in 2016?

The consensus view is that mortgage loan originations will continue to grow modestly in 2016, and that capital availability will expand or remain at 2015 levels. Interest rates remain low by historical standards, while the U.S. economy and job market continue to expand at a moderate pace, driving activity in all corners of the real estate market, from commercial office and industrial warehouse space to multi-family residential and retail. The turmoil in overseas markets will likely continue to drive foreign capital into the U.S., where commercial real estate offers an attractive risk/reward proposition relative to the equity and bond markets. Here in New Jersey, new construction will provide new opportunities to lend, particularly in the multi-family residential market along the Gold Coast and the industrial market at "Exit 8A" and other logistics hubs. And in New Jersey and beyond, a high level of refinancing activity will continue as pre-financial crisis CMBS loans continue to mature.

New opportunities to lend notwithstanding, there is more capital than there are loan opportunities. This dynamic has created stiff competition among lenders for quality deals and raises questions about whether market discipline on lending standards will continue. Last year, we asked whether 2015 would be the year in which CRE lenders (at least the unregulated ones) would become too aggressive and ignore the lessons of the pre-2008 markets. The general assessment is that this did not come to pass, and that regulatory pressures are likely to keep lending standards conservative over the next year, even if certain unregulated lenders do loosen underwriting standards to complete deals for which regulated lenders cannot compete.

In 2016, Dodd-Frank requirements and the Basel III capital reserve rules on "high-volatility commercial real estate" will keep commercial banks especially disciplined, though they will continue to make credit available for safe loans on premium properties. The lessons of the financial crisis and new risk retention requirements will likely mitigate erosion in CMBS underwriting standards this year, but liquidity in the capital markets will certainly keep CMBS lending brisk. Life insurance companies, which have honed their quality underwriting techniques over decades, will experience steady loan growth and constant market share. And with the real estate debt markets flush, private debt funds, which can make loans outside the Dodd-Frank and Basel III regimes, will likely seize on "value add" opportunities and structure lending transactions involving riskier assets.

In this environment of regulatory pressure and fierce competition, the expected modest growth will certainly be hard won. Each deal will present unique challenges, and capitalizing on new loan origination opportunities will require keen eyes for navigating compliance driven requirements and sharp pencils for pricing and structuring deals.

Environmental Insurance Can Help Manage Environmental Risk in the Development Scenario

Ann M. Waeger, Partner

New Jersey continues to be a very popular location for new development projects, both commercial and residential. However, it is common knowledge that there is a limited amount of "greenfield" land available for development in the state. As a result, developers often have no choice but to purchase land with known or potential environmental risks.

There are various tools that developers can use to manage those risks, such as environmental indemnities and escrows, but in many instances sellers of real property do not want to maintain any environmental liabilities after the property is sold. In those circumstances, the developer is forced to rely on the environmental due diligence conducted in connection with the acquisition of the property, and perhaps even assume the obligation to address known and unknown environmental conditions at the property.

Unfortunately, even with the best of due diligence - and even when a property has been remediated and received the appropriate governmental signoffs - risks remain. There is simply no practical way to test the entire property to determine whether any contamination exists. For this reason, we often suggest that parties developing a parcel of vacant land, or redeveloping a property with past or current environmental ills or risks, evaluate the use of Pollution Legal Liability type coverage (insurance that covers certain environmental risks) as an appropriate environmental risk management tool to be utilized in connection with their development activities.

Property owners can keep this type of coverage in place for the period of time during which environmental problems typically surface; while the property is being investigated, remediated, or excavated for construction purposes. In addition, a developer can maintain this coverage beyond the completion of remedial activities or beyond the construction phase of a project, in a situation in which contamination is left in place with government authorization, or where there is a substantial area of land which has not been disturbed during the remedial or construction activities. Since the discovery of contamination during the construction phase of a project can result in unanticipated project delays (in addition to the coverage for cleanup of unknown environmental contamination and for any bodily injury or property damage claims resulting from both unknown and possibly even known contamination), a key aspect of coverage for a developer to consider and not overlook is the soft costs/business interruption/extra expense coverage offered under certain policies.

Pollution liability policies have been a key environmental risk management component of numerous development projects undertaken by our clients in the past several years.

NJ Supreme Court Construction Defect Ruling Revisits Application of 10 Year Statute of Repose

Kenneth T. Bills, Partner

The time to bring suit for construction defects is governed by two separate time periods. There is a six year statute of limitations, but since the six year time frame does not start to run until the defective condition is "discovered" - and some construction defects may be latent and not come to light for years after the work is finished - a contractor could be liable for defective construction for an unlimited time.

In response to this and a trend toward the application of principles of strict liability to construction projects, the New Jersey legislature adopted a 10 year statute of repose that bars suit for "defective or unsafe" conditions brought more than 10 years after the performance of design, planning, surveying, supervision of construction or construction services.

Although the 10 year statute of repose was intended to provide certainty as to the time within which construction claims can be brought, the application has proven complex. Court decisions have established that the 10 year statute generally begins to run on the day after the issuance of a certificate of substantial completion for a construction project, but the application of the 10 year statute has continued to generate questions and litigation.

In 2015, the Supreme Court of New Jersey returned to the issue again, this time in the context of a phased construction project.

The State of New Jersey contracted with Perini Corporation to design and build a 26 building correctional facility. The project was to be constructed in three phases. Phase 1 included the central plant containing a High Temperature Hot Water (HTHW) system and inmate housing. The last two phases included additional buildings containing approximately 1000 units each, all served by the same HTHW system. A certificate of substantial completion was issued for Phase 1 on May 16, 1997, when the HTHW system was put into service and turned over to the State to operate. Certificates of substantial completion for buildings in the second phase were issued in July and October of 1997. On May 1, 1998, certificates of substantial completion were issued for the final phase.

The State alleged that the HTHW system, including both the supply and return pipelines, failed in March 2000 and on 10 subsequent occasions. Alleging that the failures resulted from design defects, improper site preparation, and defective materials, the State filed a complaint on April 28, 2008 against, among others, Perini, the HVAC contractor, the architectural and engineering design firm, and the State's own construction representative.

In *State v. Perini Corporation*, the Supreme Court of New Jersey had to decide how the 10 year statute of repose applied to a phased project and whether the State's complaint was barred as a result. The court rejected the contractor's claim that the 10 year statute started to run when the certificate of substantial completion was issued for Phase 1 and the HTHW system was put in operation and turned over to the

State. The Court ruled instead that the HTHW system was not complete until all of the buildings it was intended to serve had been connected, and that in the context of a phased project where the phases "seamlessly" flow into one another, the 10 year statute on the HTHW system began to run on the issuance of the certificates of substantial completion for the final phase. Accordingly, notwithstanding that the State had been in control of the HTHW system for nearly 11 years when it filed its complaint, the defendants (whose services continued until the end of the entire project) were not protected by the 10 year statute of repose.

Interestingly, the Court suggested in a footnote that the parties could have specified a substantial completion date in their construction contract. Had the contract specified a separate substantial completion date for the HTHW system, the result might have been different.

Accordingly, this decision provides one more reason why an owner, contractor, design professional or subcontractor should be sure to have their construction and design contracts reviewed by an attorney who can assist in structuring the terms in the most favorable manner.

Affordable Housing Determinations Are On the Horizon

Steven Firkser, Counsel
John H. Hague, Partner

The year 2016 is expected to bring court determinations regarding the requirements for New Jersey municipalities to provide their fair share of affordable housing for low and moderate income families. As a result of the Supreme Court of New Jersey's March 10, 2015 decision, which stripped the Council on Affordable Housing (COAH) of oversight, the determination of affordable housing compliance is now being addressed by 15 designated *Mount Laurel* judges throughout the state.

The Supreme Court, holding that COAH had failed to provide the necessary regulations to ensure the construction of housing for low and moderate income families, established a process for municipalities that had previously participated before COAH to have a determination on their compliance requirements before designated trial judges. More than 375 municipalities have filed declaratory judgment actions for such determinations, as well as seeking temporary immunity from exclusionary zoning and builders remedy actions. Many interested builders have moved to intervene in these actions to have their properties and projects included in the municipal plans.

Early in 2016, the *Mount Laurel* judges will be considering expert reports submitted by both municipalities and housing advocates, and will be conducting trials to establish the fair share numbers for each municipality. The municipalities must then file housing plans that satisfy those obligations and demonstrate how lower income units will be provided. If the housing plans fall short, interested developers can seek to contest the validity of the municipal fair share plans and seek to include their properties with an affordable housing component. By the end of the year, builders should have more

certainty as to the rezoning of sites to accommodate affordable housing.

In the interim, developers seeking approvals for residential projects, including changes in zoning and variances, face a climate of uncertainty and unpredictability. In situations where municipalities have adopted ordinances based on the invalidated portions of the prior COAH regulations, the inclusion of affordable housing or the development fees may exceed that which will ultimately be required once the judicial process is concluded. Developers seeking changes of use for properties will have to confront the issue of providing support for affordable housing without clear guidance as to how this will be accomplished. Municipalities are not relieved of the constitutional obligation to provide realistic opportunities for affordable housing during the interim period.

In the context of redevelopment, we have seen a municipality use the approval of designation as a redeveloper to exact an inclusionary housing percentage in excess of that required by its existing ordinance. We have also seen an instance where one of the affordable housing judges has issued an order providing that residential housing approvals at the municipal level will not have the benefit of the protections from ordinance change found in the Municipal Land Use Law, unless there is a specified inclusionary component or the approval is otherwise approved by procedures set forth in the order. The order creates a safe harbor with respect to the specified inclusionary requirements, which functionally serves as a mandate, as developers and lenders are unlikely to proceed with development under risk that the underlying ordinances may change.

The interim period does create some unlikely opportunities. For instance, a municipality that intends to build its own exclusively affordable projects may be prone to accept contributions from non-inclusionary projects to demonstrate the financial feasibility of affordable projects they are pursuing. In other words, a zone change to a higher density project with a developer's fee may be desirable to certain municipalities.

Given the lack of uniformity, the circumstances of each municipality will have to be evaluated to develop an appropriate strategy. Although there may be some opportunities, developers and property owners should not expect an expedient resolution of issues concerning affordable housing during this interim period.

NJ Supreme Court to Tackle Important Condominium Damage Coverage Case

Steven G. Mlenak, Associate

The New Jersey Supreme Court has granted certification in an important case which could impact condominium construction defect and transition litigation going forward. In a published decision in *Cypress Point Condominium Association, Inc. v. Adria Towers, LLC*, the Appellate Court held for the first time that the presumably unintended and unexpected consequential damages caused by a subcontractor's defective work constituted both an "occurrence" and "property damage" under the developer's commercial

general liability (CGL) insurance policy. In doing so, the Appellate Court departed from years of judicial rulings that such damages were not recoverable from a developer's insurance policy.

In *Cypress Point*, a condominium association sued the developer, the developer's insurance carriers and the developer's subcontractors for damages to the property resulting from faulty workmanship performed by the subcontractors. As part of its lawsuit, the association sought coverage from the developer's insurance carriers for the consequential damages caused by the faulty work. This included water infiltration from the roof and windows to interior units and damages to the building's support structure, sheathing, sheetrock, and insulation, among other damages. The insurance carriers argued that faulty workmanship is not considered "property damage" or an "occurrence" under their policies but is rather a "business risk" inherent to the developer. The carriers relied upon existing case law in insisting that coverage for these damages be denied to the association. The association argued that while the replacement or repair costs for the work itself may not be covered, the consequential damages resulting from the faulty work should be considered an "occurrence" and "property damage," and should therefore trigger coverage under the insurance policy.

The trial court relied on the established precedent in finding for the carriers. The Appellate Division, however, reversed the trial court in favor of the association, holding that the consequential damages which resulted from the faulty work did constitute an "occurrence" under the policy.

Since its July 2015 holding, the Appellate Court has already relied upon *Cypress Point* in both *Bob Meyer Communities, Inc. v. James R. Slim Plastering, Inc.* and *Belmont Condominium Association, Inc. v. Arrowpoint Capital Corporation*, finding that consequential damages to the associations in both cases constituted an "occurrence" under each developer's insurance policies.

If the Supreme Court affirms the Appellate Court in *Cypress Point*, it will have a significant effect on construction defect and transition litigation for condominium associations throughout the state. Primarily, associations would be able to seek coverage from the developer's insurance carrier for consequential damages caused by faulty workmanship with greater confidence than before. Being able to recover such damages from the insurance carrier would in turn decrease the amount of uninsured damages sought by associations from developers, which could simplify settlement negotiations. For these reasons, the Supreme Court's handling of *Cypress Point* will warrant close attention.

Co-Tenancies in Retail Commercial Leases:The Anchor Tenant

Steven C. Delinko, Partner

While corporate bankruptcies and reorganizations currently do not appear to be on the rise, the New Jersey market continues to experience a fair amount of retail store closures (both temporary and permanent) by anchor stores and other substantial tenants in shopping centers and strip malls throughout the state. We are also still working through the fallout from 2015 corporate bankruptcies and

reorganizations where the decision to close certain retail stores or permit those retailers to temporarily "go dark" continues to have a significant impact on commercial landlords and tenants alike due to co-tenancy provisions in the leases of other tenants in those centers and malls.

Co-tenancy provisions primarily consist of an "opening co-tenancy" provision which provides that a tenant need not open, or need not open and pay full rent, unless another store(s) in the center or mall is open; and an "operating co-tenancy" provision which provides that a tenant may pay reduced rent and/or have the right to terminate its lease in the event another store(s) in the center or mall ceases to operate. This article will address the latter circumstance, where the operating co-tenancy is tied to the operations of the key or "anchor tenant" of the center or mall.

Tenants are eager to accept operating co-tenancy provisions because they provide the tenant with remedies in the event the center or mall ceases to perform as it did previously due to the cessation of operations by the anchor tenant. Landlords, on the other hand, resist operating co-tenancy provisions because they claim they cannot control the actions of the anchor tenant. Notwithstanding the logic of the landlord's position, operating co-tenancy provisions exist and will continue to exist, and must therefore be addressed thoughtfully and carefully.

A typical operating co-tenancy provision will, after a reasonable period of time following the anchor tenant's cessation of operations, initially provide the tenant with monetary relief in the form of a partial or full abatement in its minimum rent. To the extent the cessation of operations continues for an extended period of time, it will also provide the tenant with a right to terminate its lease. While the time periods are certainly negotiable, the landlord may require that the tenant not be in default of its lease, and that the tenant demonstrate a decline in sales during the period of the anchor tenant's cessation of operations.

The operating co-tenancy provision should provide the landlord with a reasonable period of time to cure the operating co-tenancy violation or replace the non-operating anchor tenant. The adverse consequences to the landlord as a result of the affected tenants invoking the remedies provided to them in the operating co-tenancy provision justify including such reasonable periods of time, as the landlord will have to identify and obtain a substitute anchor tenant; negotiate the lease; and most likely perform improvements or allow the substitute anchor tenant to perform improvements to the anchor premises.

If not properly handled in the lease, the operating co-tenancy provision can be potentially devastating to landlords. However when properly handled, the operating co-tenancy provision can provide significant and welcome relief to affected tenants.

Both landlords and tenants are advised to review and carefully consider the co-tenancy provisions in their current standard form of leases, as well as the provisions in leases currently in effect. It is critical to examine whether the respective interests of both landlord and tenant are adequately and properly addressed. As tenancies change, and as leases are negotiated and renewed, the opportunity to implement or revise language that clearly reflects the intent of the respective parties may be presented.