WINTER 2006

PERSPECTIVES

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COX, CASTLE & NICHOLSON LLP has devoted nearly 50 years to providing a broad range of legal services to the real estate industry. The Firm represents publicly and privately held businesses, major financial institutions, public agencies, pension funds, underwriters, developers and industry entrepreneurs in their respective real estate activities.

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DOES YOUR BUSINESS NEED DISASTER INSURANCE

by Patrick McGovern

Hurricane Katrina serves as a reminder to the business community that natural disasters can have devastating consequences. Unlike most other insurable losses, those caused by natural disasters have the potential to put an organization out of business. While expensive, disaster insurance is generally available and all businesses should review their insurance programs to ascertain whether they have appropriate and adequate protection.

In some parts of the country, the risk of a particular type of natural disaster may be extremely remote (*e.g.* hurricanes in California), but most states in the country are potentially subject either to earthquakes or to hurricanes (or both) and floods can happen just about anywhere.[1]

> ***Every business should understand its existing disaster insurance and make informed decisions on whether its coverage needs to be broadened***

The Risk Of Natural Disaster Is Not That Remote

Florida is undoubtedly the state with the greatest exposure to hurricanes. Of the 158 hurricanes that hit the United States between 1900 and 1996, 47 hit Florida. But coastal states from Texas to Maine are all at risk for hurricanes, as is Hawaii. Prior to Hurricane Katrina, Hurricane Andrew in 1992 was the most expensive catastrophe in U.S. history with insured losses of $15.5 billion.

After fire, flooding is the most common and widespread of all natural disasters. Most communities in the United States have experienced flooding as a result of either spring rains, heavy thunderstorms, hurricanes or winter snow thaws. To varying degrees, all areas are susceptible to flooding, but it is to be noted that 25% of flood claims occur in the low-to-moderate risk areas.

The risk of earthquakes is also widespread. Since 1990, earthquakes have occurred in 39 states and caused damage in all 50. Those who live west or just east of the Rockies are at most risk, but so are those people living in Alaska, New England and in the New Madrid Fault area along the Mississippi. A total of 39 states have a medium to high potential for quakes, and roughly 90% of all Americans live in areas considered seismically active. However, the most earthquakes and the most costly earthquakes take place in California. Nine of the ten most costly earthquakes in the last century occurred in California: the Northridge earthquake in 1994 cost at least $12.5 billion dollars in insured losses and (prior to Katrina) was the second most expensive natural disaster in U.S. history.

So, for most businesses, the risk of being impacted by one kind of natural disaster or another is in fact not that remote. And if it happens, a natural disaster has the potential to be a financially devastating event. In fact, 25% of all businesses that shut down after a natural disaster never re-open their doors. For small and large businesses alike, adequate insurance protection may be critical to survival.

Disaster Insurance Is Generally Available

Hurricane, flood and earthquake insurance is available in most parts of the country, but in disaster-prone areas it may be necessary to go to a federally or state-sponsored insurance program (or pool) to obtain coverage.

In many states, standard commercial property insurance policies typically cover

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DE-MALLING A SHOPPING CENTER — A DEVELOPER'S TOP TEN ISSUES

by Matthew P. Seeberger

Much of our country is replete with shopping malls, many of which were constructed years (sometimes decades) ago and now may be viewed as "tired". Nonetheless, many of those malls have the top three attributes of desirable real estate – "location, location, location" – and thus remain attractive investments in spite of their current problems, needing only some sort of renovation to rejuvenate the asset. One strategy which is often considered by a developer in such a situation is "de-malling", which includes a variety of actions, but primarily involves removing the roof over the common area of a mall. Although de-malling can be a viable alternative, a developer must carefully consider a variety of factors before it commits to such a course of action. This article will briefly review a number of considerations to be taken into account when evaluating whether de-malling is appropriate.

1. Reasons Renovation Needed. Some of the major reasons a shopping mall may need renovating are decreased pedestrian and vehicular traffic and demographic changes. For example, a center which was at the forefront of early suburbanization when its was built may have witnessed a decline in disposable income due to the aging of the surrounding areas (in terms of the residents and the housing stock) and the movement of growth to newer suburbs. Or, an influx of immigrants (whether a mix of ethnic groups or comprised primarily of a particular ethnic group) could result in a dramatic change in spending and shopping patterns in the mall's trade area. In either situation, the existing mall structure may no longer be optimal, being either too expensive (both from a maintenance/operating cost and/or pricing of goods perspective) or simply being "foreign" to the new dominant group of potential customers, either of which may doom the existing tenant mix to lackluster sales growth, or even declining sales. Alternatively, the surrounding area may have gentrified and the new customer pool may be more interested in contemporary developments in shopping, such as more upscale "lifestyle" centers.

2. Who Are the Anchors, Majors and Other Land Owners? Anchors, majors and/or other land owners in older malls often use a renovation project as an opportunity to extract concessions from a developer which were not anticipated when initially considering the project, and de-malling can offer considerable opportunities for such concessions for an anchor, major or land owner. These concessions may range from financial (in a recent de-malling project, an anchor/major refused to consent to the renovations unless the developer agreed to spruce up the exterior of its store), to more floor area (that same anchor also insisted on the right to expand its store or to develop outparcels on its land), to greater signage (the addition of a large new anchor/major prompted others to demand new signage rights, including changing the priority of the existing signage). Or, simple indifference may prevail (in a recent de-malling project, a ground lessor of an anchor/major, which had essentially obtained the bulk of the benefits from a sale-leaseback financing transaction and had minimal rental income to look forward to for up to 60 additional years, would not even discuss a developer's plans as it saw no benefit to itself).

> *Local governments usually are receptive to renovating an outdated shopping mall, but may have different priorities, such as upgrading public transit access, upgrading fire ratings for existing structures, or increasing sales taxes*

3. Who Is the Lender? Although a lender obviously wants its borrower to succeed, a lender usually is more focused on ensuring that its collateral does not suffer a decline in value, which could lead to a foreclosure. Therefore, a lender may have different ideas about what is best for the success of the center. For example, a developer may be primarily interested in getting a "big box" retailer to come into the center to increase customer traffic and draw higher credit regional and national tenants (as opposed to being weighted with "shop" tenants, which generally pay lower rents), and thus be willing to make significant accommodations to such a retailer to get it under contract. Conversely, a lender may be more concerned that the developer is making too many concessions to the retailer, which when aggregated might jeopardize the developer's ability to complete the renovation in a manner which benefits the entire center.

4. Relocating Existing Tenants. In any renovation, it will be necessary to move a number of tenants to other spaces in the center. Although most shop leases will allow a landlord to relocate a tenant in the event of a major renovation, they usually also require that the tenant's business operations not be disrupted in a significant manner. For larger tenants, the relocation right may be limited to a particular area in the center, or simply be non-existent – in either case, it may take additional concessions to convince the tenant to move. In addition, scheduling the relocation of tenants, when combined with scheduling work on the common areas and constructing new tenant spaces, can be a daunting challenge.

5. What Is the Status of the CC&Rs? Many older centers have covenants, conditions and restrictions (CC&Rs), which govern the use of the shopping mall.

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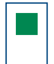


MASTER LEASES IN FINANCING TRANSACTIONS

by Douglas P. Snyder

Master Leases In Financing Transactions

Financing a commercial real estate project based on its rental stream brings many challenges for a property owner. Deficiencies in that rental stream only increase these challenges, whether the deficiencies arise from vacant space, scheduled lease expirations, tenant concessions (such as free rent) or other lease attributes that are scrutinized in the lender's underwriting process. Some lenders seek to have perceived rental deficiencies covered by requiring a "master lease".

A master lease is a lease of all or some portion of a commercial project signed by a creditworthy master tenant to provide an additional or back-up rental stream for the project. The master tenant is typically a principal or affiliate of the borrower entity owning the project, which is the landlord. The master lease is assigned to the lender as collateral.

Master leases can be structured in many ways, but their common purpose is to provide the income stream necessary to support project financing. Some common structures include:

- The master tenant leases the entire project, and is deemed to be subleasing space to tenants in occupancy of their space;
- The master tenant leases specific vacant space only, and the master lease terminates with respect to space later leased to tenants in occupancy;
- The master lease covers only the vacant space in the project from time to time, so that the master premises "float" to coincide with actual vacant space;
- The master lease covers specific space covered by a lease with an upcoming expiration, and takes effect only if that lease is not renewed or the space released;
- The master lease covers space leased to a tenant currently paying no rent due to a rent abatement period, but only during such period.

If the master lease was given as credit enhancement for the loan, in the event of the owner's default, the master lease performs the same function as a guaranty. The lender is looking to the master tenant as a secondary source of recovery after the lender has foreclosed on the project. At that point, the new landlord - the lender or other successful bidder at foreclosure - would seek to collect rent payments due under the master lease as a source to recover its investment.

> *In California there is a significant chance that upon court scrutiny a master lease will be treated as a disguised guaranty of the loan*

As explained below, in California there is a significant chance that upon court scrutiny a master lease will be treated as a disguised guaranty of the loan. Whether a master lease is treated as a true lease or a guaranty will have significant implications to both the master tenant and the lender.

Recharacterizing A Master Lease

Under certain circumstances, California courts will not honor the form in which a transaction has been documented if the true intent of the parties was a different type of transaction with different legal results. The decisions in these types of cases rely very heavily on the individual facts of each case.

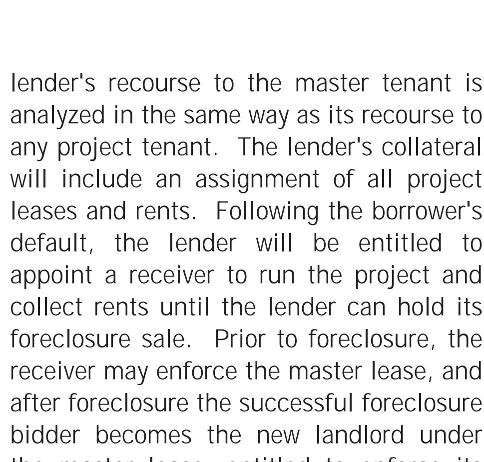
No cases in California have directly addressed the issue of treating a master lease as a disguised guaranty. However, legal scholars widely believe that a California court would have no trouble coming to this result if requested by the master tenant. Questions a court must address include:

- Was the master lease a condition to the lender making the loan?
- Is the master tenant a party who might otherwise have given a guaranty?
- Does the rent called for under the master lease produce just the amount of project income necessary to meet the lender's underwriting standards?
- Did the master tenant never occupy the property?
- Did the lender treat space leases as direct leases to the borrower rather than as subleases?

If the answer to some of these questions is "yes" there is a significant chance the master lease will be treated as a guaranty. Alternatively, if these facts do not appear and there is an independent business purpose for the master lease which is on market terms, the master lease should be treated as a true lease. Many master leases will fall into the gray area between these extremes, and it is hard to predict how they will be treated.

Master Lease As A True Lease

The difference between treating a master lease as a true lease and a disguised guaranty can be very significant. When a master lease is viewed as a true lease, the



lender's recourse to the master tenant is analyzed in the same way as its recourse to any project tenant. The lender's collateral will include an assignment of all project leases and rents. Following the borrower's default, the lender will be entitled to appoint a receiver to run the project and collect rents until the lender can hold its foreclosure sale. Prior to foreclosure, the receiver may enforce the master lease, and after foreclosure the successful foreclosure bidder becomes the new landlord under the master lease, entitled to enforce its terms. If the master tenant does not pay its rent upon demand by the receiver or new landlord, it will be in default under the master lease.

The standard remedy for California landlords to collect rent from tenants in default is to terminate the lease and sue the tenant for delinquent rent and future rent through the end of the lease term. Different rules apply to delinquent rent and future rent. With respect to delinquent rent, the landlord may sue for up to four years of past delinquencies, after any subrents or other payments are taken into consideration. With respect to future rents, the landlord is entitled to recover the amount of rent scheduled under the master lease through the end of its term, less anticipated rents from other tenants (including existing space tenants) through the end of the master lease term. The future rents, after credits for other tenants, would be discounted to present value at the Federal Reserve discount rate plus 1%.

A master lease can be an effective tool for a commercial property owner to enhance its financing opportunities

Assuming the master tenant is in default under the master lease, a lawsuit against the master tenant seeking to collect these amounts could be commenced any time after a receiver is appointed or a foreclosure sale is held.

Master Lease as a Disguised Guaranty

If a court determines the master lease should be recharacterized as a guaranty, it will rewrite the master lease to follow what it believes was the true intent of the parties. The first question the court must face is determining the amounts guaranteed. Assuming the master lease was signed to provide sufficient income to service the loan, a natural conclusion would be that the master lease constitutes a guaranty of debt service up to the amount of rent called for under the master lease. The guaranty might also cover payment of taxes, insurance and any common area maintenance charges at the project.

The lender would make demand on the master tenant to pay the guaranteed amounts, and if not paid the lender would bring a lawsuit to enforce the "guaranty." Under California law a guarantor has various defenses to guarantees, known as "suretyship defenses." While most guaranty documents provide waivers of these defenses, a master lease would not normally contain these waivers. The master tenant may be able to raise suretyship defenses, which include the right to require the lender to first exhaust the lender's remedies against its collateral (the project) and the borrower before seeking recovery against the master tenant. One suretyship defense is based on the California case of Union Bank v. Gradsky, and is normally the subject of detailed waivers in a guaranty document. Without these waivers, the lender seeking to enforce the master lease as a guaranty would be forced to bring a lawsuit for judicial foreclosure and seek to hold the master tenant liable for a deficiency following completion of the lawsuit and its judicial foreclosure sale. This deficiency judgment would be limited by the "fair value" rule of California Civil Code Section 726, which is designed to prevent lenders from profiting from below-market bids at judicial foreclosure.

Some lenders attempt to address this problem by including suretyship waivers in the master lease document. This should assist in enforcing the master lease if it is recharacterized as a disguised guaranty. However, this language in a master lease would clearly show that the parties were cognizant of this risk and may be used as evidence that the parties intended a guaranty rather than a true lease. Both the benefits and risks of including guarantor waivers in a master lease should be carefully considered.

Effective Use of Master Leases

A master lease can be an effective tool for a commercial property owner to enhance its financing opportunities. Whether this legal obligation should be structured as a master lease or a guaranty of cash flow or debt service should be carefully considered by the borrower and lender, with the advice of counsel. In most cases there will be a structure that meets the needs of both parties, and this can be implemented while minimizing the risk of later recharacterization by a court and the unintended results that follow.

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DE-MALLING A SHOPPING CENTER — A DEVELOPER'S TOP TEN ISSUES, cont'd

CC&Rs are often entered into by the various owners of the land under the center, although anchors/major tenants also often have rights regarding what can be done with respect to the center's common area, which usually is owned by the developer. The primary difficulty in such a situation is that frequently the unanimous agreement of all of the parties to the CC&Rs is required to effect any significant change, and anchors, majors and other land owners will often use a needed change to the CC&Rs as a way to obtain concessions.

6. Cooperation With/From Local Government. Local governments usually are receptive to renovating an outdated shopping mall, but, as with lenders, anchors, majors and other land owners, a local government may have different priorities, such as upgrading public transit access, upgrading fire ratings for existing structures, or increasing sales taxes. While this will not usually prevent a renovation project from occurring, it can lead to delays and additional costs due to the need to reconcile the various parties' concerns.

7. You Can't Please Everybody. While developers want to maintain good relations with tenants, there are times when it is necessary to make a decision that does not coincide with a particular tenant's desires. For example, tenants may raise concerns regarding a decrease in business due to the renovation, a rent increase following the renovation, and the cost of renovating its own store if outdated, among other concerns.

8. Make Sure You Have the Right Consultants. It is critical to have the right consultants when undertaking a project as complicated as de-malling a shopping center. This may mean bringing in new people, but it may also mean keeping those who have knowledge of the center. For example, an in-house mall manager is likely to know the character of the various tenants and the physical condition of the structures, and thus is an invaluable resource in determining which tenants to keep and what areas of the center may need work. Engineers, architects and/or contractors who have done similar projects and/or have worked with the relevant local government can provide key assistance in shepherding plans and specifications through building and planning departments. Leasing agents can provide contacts for the types of tenants that may be interested in coming into a renovated property. And a project manager to oversee all of the various aspects is strongly recommended.

9. Expect the Unexpected. No matter how much foresight a developer puts into planning, there will always be unexpected delays and costs. In a recent de-malling project, a developer was hoping to do most of its construction work in the summer. Due to delays, much of the work was not started until late fall, which meant that when Los Angeles suffered its second wettest year on record, the developer was forced to deal with flooding of existing spaces and the inability to make meaningful headway in grading for a new anchor store, which led to further delays and increased costs.

10. Climate. De-malling involves opening up your shopping center to the elements. As such, it is an endeavor best suited to moderate climates where extreme cold or heat are not dominant characteristics of the regional climate.

In determining whether de-malling a shopping mall is feasible and economically viable, there may be factors other than the foregoing that may need to be addressed, but the above ten issues will, more likely than not, need to be considered by a developer when contemplating the de-malling process.

upcoming

Loryn Dunn Arkow, a joint venture and acquisition attorney in our Los Angeles office was promoted to partner.

Kevin Crabtree, a joint venture and acquisition partner, relocated to our San Francisco office.

Robert Doty will be a speaker at the 2006 **National Colorado Bar Association Conference** January 5, 2006 in Snowmass, Colorado.

Joanna Huchting will participate in a panel discussion at the **National Association of Home Builders Construction Law Forum** January 15, 2006 in Orlando, Florida.

Adam B. Weissburg will participate in a **PLI** panel discussion January 26, 2006 in San Francisco, California. Visit www.pli.edu or call 800.260-4PLI for more information.

Robert Doty will be a speaker at the 2006 **California State Bar Section Education Institute** January 28, 2006 in Santa Monica, California.

Jeff Masters will be a speaker at the **Advanced Strategies For Avoiding Litigation** seminar February 21, 2006 at Sheraton Palace, San Francisco, California.

DOES YOUR BUSINESS NEED DISASTER INSURANCE, cont'd

damage from windstorms, so most businesses will not need to add anything to secure coverage for hurricanes. However, in those states that are most prone to hurricanes, protection against windstorms does not come as part of the standard package, and it may even be necessary to look for coverage from one of the state-sponsored windstorm coverage pools. Also, even if a standard commercial property policy does provide windstorm coverage, the damage that results from flooding caused by a hurricane will ***not*** be covered because coverage for flooding is usually excluded from such policies, regardless of whether or not it is wind-driven.

Standard commercial property insurance policies do not cover either damage caused by flooding or damage caused by earthquakes. But coverage for floods and earthquakes can sometimes be endorsed onto the property policy, and these coverages are also available under separate policies specifically written to provide such coverage.

Flood insurance is written under the National Flood Insurance Program (NFIP), a federally funded program which makes flood insurance available at a reasonable cost for properties in flood zone areas. Policies issued under the NFIP will cover up to $500,000 for commercial buildings and $500,000 for their contents. A fairly limited number of private insurance companies also offer flood insurance policies. Excess flood insurance is often written by these private insurance carriers over the NFIP program.

Outside of California, earthquake coverage can be purchased in most states from regular insurance companies. In California, most policies are sold by the California Earthquake Authority (CEA), which is the state–run insurance pool. Some private companies also sell earthquake insurance. Earthquake insurance is usually provided in layers up to, or exceeding, the "probable maximum loss" (PML) of the property.

Physical Damage, Loss Of Income And Additional Expenses Can All Be Covered

Assuming that a loss is a covered loss, commercial property policies (including windstorm, flood and earthquake policies) will generally cover physical damage to the buildings and other structures identified in the policy, as well as damage to fixtures, machinery and equipment, furniture, stock and other personal property. There may also be some coverage (possibly available as optional additional coverage) for the cost to restore or replace electronic data and valuable papers and records.

However, the costs of a disaster will likely extend beyond the physical damage to buildings and personal property. As long as its usual location is not available, a business will probably face both a loss of income and additional expenses as a result of efforts to continue normal business operations. And if the building is not owned outright by the business owner (as is typically the case), this should also be a concern for the landlord. For if the tenant is put out of business due to a natural disaster, that tenant is not likely to be concerned about continuing to pay their rent.

The good news is that, if a policy is appropriately endorsed, business interruption insurance will cover loss of income suffered by the business as a result of not being able to use premises damaged by a covered cause of loss. And extra expense coverage will cover expenses in excess of normal operating expenses that are incurred to continue operations after a direct damage loss, such as the cost of operating from a temporary location. Business owners are well advised to consider purchasing such coverage, and landlords are well advised to at least consider requiring it of their tenants.

Every Business Should Understand Its Existing Disaster Insurance and Make Informed Decisions On Whether Its Coverage Needs To Be Broadened

In planning for disasters, the important points for any business are to identify the potential exposures to natural disasters in all those locations where the business has an operation, to know the scope of disaster coverage under its existing insurance program, and to make an informed decision about whether it needs to broaden the scope of that coverage.

Disaster insurance is expensive, especially in the most disaster-prone parts of the country. Also, the deductibles for windstorm coverage and for earthquake insurance tend to be high. (Federal flood insurance comes with much lower deductibles.) But these negatives have to be weighed against the potential financial consequences of being hit by a natural disaster and not having adequate or sufficient insurance in place to respond. The ultimate question is, could you afford not to have insurance if a natural disaster struck? At least for the 25% of businesses that were shut down in the past by natural disaster and never reopened, the answer was – no.

[1] *This article will not address them, but there are of course other forms of natural disaster besides floods, hurricanes and earthquakes, including fire, volcanoes, tornadoes and tsunamis. Then there are the man-made disasters, such as terrorism and war.*

LOS ANGELES

2049 Century Park East, 28th Floor
Los Angeles, California 90067-3284
P 310.277.4222 F 310.277.7889

ORANGE COUNTY

19800 MacArthur Blvd., Suite 500
Irvine, California 92612-2435
P 949.476.2111 F 949.476.0256

SAN FRANCISCO

555 Montgomery St., Suite 1500
San Francisco, California 94111
P 415.392.4200 F 415.392.4250

www.coxcastle.com

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