2017 Real Estate Update: Trending Issues & Topics of Interest

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As we continue our transition to a new administration in Washington, D.C., the commercial real estate community anxiously awaits a roll-out of the well-publicized tax reforms campaigned on by our new President and supported by the Republican majority. Many wonder how the new policies and potential legislative changes will impact the real estate sector, both on a national scale and here in New Jersey.

Will the promised reforms stimulate continued and expanded growth in New Jersey's real estate marketplace at large? Will the office and retail markets nevertheless continue to lag behind the multi-family and industrial markets? Will the energy sector continue benefiting from public incentives?

Or ... as the "buzz" reported by members of our Real Estate Department seems to indicate - is the formation of new funds, centered on distressed real estate, a foreshadowing of the real estate industry's future?

As we continue to move forward against a backdrop of these (and other) unanswered questions, we thought it would be helpful to examine some of the key issues we've observed in the past year and offer our perspective on how these issues may impact our clients and their businesses.

We hope you find our insights relevant and valuable. We welcome your thoughts on the topics addressed in this newsletter, and are available to discuss any of the issues and their potential bearing on individual portfolios and overall business strategies.

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The Ongoing Evolution of New Jersey's Industrial Market

Jack Fersko, Department Co-Chair

The industrial market here in New Jersey continued to shine throughout 2016, and predictions are for a strong showing in 2017. According to research prepared by Jones Lang LaSalle (JLL), net absorption in 2016 reached approximately 10 million square feet, a level not seen since 2001. In addition, JLL reports that almost 7 million square feet of new construction is in the pipeline for delivery in 2017.

What's driving the persistent growth of the industrial sector during the past few years? The ongoing expansion of the e-commerce industry, demand for "last mile" delivery space, and the continued development of urban centers and transit-oriented municipalities are surely important factors. As a result, we're witnessing a decreasing amount of developable land and a steady increase in industrial rental rates.

The sustained vibrancy of the industrial market has laid the framework for some interesting trends and developing issues to watch going forward. Much has been written about increased ceiling clear heights, column spacing, newly designed loading docks, truck parking and truck turning radius, as well as multi-story warehouses. What might we see as a focus in the future? Some broadly anticipated trends include the design of space for use with drones and to accommodate autonomous vehicles. A recent article by Christopher Lee of CEL & Associates, Inc., published in NAIOP's *Development Magazine,* cites the continued expansion of robotics that bring unique noise, temperature and air quality control issues to the table. Also, as demand for "last mile" space grows, many suggest the potential repurposing of former big box retail space, since such space has appropriate parking, ceiling height and loading dock facilities already in place.

In light of these game-changing potential developments, here are just a few of the multitude of issues to keep in mind:

- If property is being repurposed from retail to a warehouse and distribution use, is the property zoned for the intended new use?
- Are there any municipal or federal land use regulations restricting the intended site development (including multi-story development, ceiling height, truck parking, turning radius and potential future use of drones)?
- Are there sufficient due diligence rights to permit a proper investigation for environmental concerns, including potential vapor intrusion issues and required mitigation?
- If a transaction involves a build to suit lease, have the many unique issues facing both the landlord and the tenant been accounted for, including approval contingencies, timing-related issues and the consequences of failing to meet timeframes, landlord financing, enhanced tenant security issues, as well as construction related issues?
- Will the property be acquired by way of a ground lease, and if so, have proper protections been built into the lease structure to ensure a financeable ground lease to facilitate the tenant's project financing

while still protecting the legitimate interests of the landlord and any fee mortgagee?

The industrial marketplace will continue to provide much excitement in 2017. If, as some maintain, industrial space is truly the new "retail" space, will percentage rent find its way into future industrial lease transactions? Stay tuned!

The Indispensable Benefits of a Team Approach

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

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The practice of real estate law in the 21st century has changed significantly from the days when commercial real estate transactions could generally be handled by a single jack-of-all-trades practitioner. The complexities of the law and their accompanying regulations, breaking developments related to advances in technology, changing demographics and societal factors, and constantly evolving case law converge to create a sophisticated transactional environment that calls for an equally sophisticated team approach to the legal issues that may arise during the acquisition, sale and leasing of commercial properties.

In a recent deal handled by the firm, for example, our client was relocating its headquarters to an urban redevelopment area where it had signed an agreement to purchase a vacant lot from a county improvement authority. A team of seven attorneys from our Real Estate, Redevelopment & Land Use, and Environmental Departments worked as a collaborative unit on the client's acquisition.

The work involved negotiating a redevelopment agreement (with twelve amendments), construction and engineering contracts, an architect's agreement, and cross-easements for access, utilities and parking. We advised the client on the numerous environmental issues that arose during due diligence, including the issuance of a Response Action Outcome for over twenty areas of concern and for historic fill. We obtained and perfected subdivision approval and negotiated an escrow agreement with the seller for the costs of construction of a parking lot by our client's contractor on the seller's adjoining property. We reviewed title to the property, which was an assemblage of many lots that the seller had acquired by voluntary conveyances and tax sale certificate foreclosures, and cleared various title defects that were identified during our review. We coordinated the process of vacating public rights in an alley adjoining the property, obtained an abatement from the payment of real estate taxes on the new improvements (which were located in a Garden State Growth Zone), and advised the client concerning Urban Enterprise Zone benefits. The transaction took three years from inception to closing.

In another recent deal, the firm represented a client as lead counsel on the acquisition of a 300 unit luxury apartment complex consisting of 30 buildings located on a 46 acre site for a purchase price of $56 million. The acquisition was effectuated through the purchase of equity interests of the company that owns the

real estate.

A few months prior to our client's involvement with this transaction, our client's co-venturer became the contract purchaser. Although the co-venturer was an experienced real estate investor and manager, they were at risk of defaulting under the purchase agreement due to a lack of sufficient capital to close the transaction on the scheduled closing date. With less than four weeks remaining before the closing, the co-venturer was introduced to our client, who retained our firm to represent it in connection with the joint venture. We quickly assembled a team of attorneys from the Corporate, Real Estate, Tax and Environmental Departments since the complexities of the transaction required a multi-disciplinary approach. Importantly, we assisted the client in structuring the transaction in a manner that avoided a potential $1 million tax liability. We also handled the negotiation of a mortgage loan to one of the entities involved in the transaction, and a mezzanine loan to a different entity in the organizational structure. We prepared and negotiated a joint venture agreement and a property management agreement between our client and the co-venturer. In doing so, we struck a careful balance between providing the co-venturer with a certain amount of discretion to manage and operate the property, since our client was relying on the co-venturer's operational experience in running similar properties, while simultaneously including provisions in the agreements to safeguard our client's substantial equity infusion into the transaction.

While the acquisition was primarily a corporate and commercial real estate matter, our knowledge of residential landlord-tenant law came into play as we counseled our client on how to bring its form of residential lease intended for use at the apartment complex into conformance with New Jersey's laws relating to residential tenancies. Despite the short time frame between the date we became involved in the transaction and the scheduled closing date, we helped our client navigate through these and other legal issues that arose throughout the transaction to successfully close on time.

The practice of staffing a transaction with attorneys from several disciplines assures clients that every aspect of their matter will be handled by an experienced attorney with the skill set needed to provide practical solutions to whatever legal problems arise. Going forward, there is no doubt that the practice of real estate law will continue to demand the sophistication of a multi-disciplinary approach.

A Tough Pill To Swallow: The Potential Impact of Affordable Care Act Reforms On Commercial Landlords

Matthew J. Schiller, Partner

2017 will undoubtedly signal significant changes on the healthcare reform front. The Trump Administration and a Republican-controlled Congress will continue efforts to dismantle the Affordable Care Act (ACA) through executive orders, funding cuts, moratoriums and regulatory reforms. These actions will have sizeable impacts on the insurance industry, especially for private companies and plans created under and/or expanded through the ACA.

It is both reasonable and prudent to anticipate a ripple effect that will impact commercial property landlords, who should understand their rights and obligations under their leases and state law in the event that insurance industry tenants become financially distressed as a consequence of ACA reforms.

For example, the ACA authorized the establishment of certain private Consumer Operated and Oriented Plans (CO-OP) to "foster the creation of qualified nonprofit health insurance issuers to offer qualified health plans in the individual and small group markets." CO-OPs were originally envisioned to be consumer-friendly alternatives to for-profit insurers and a means to increase competition within the insurance industry, resulting in more insurer choices and greater coverage options. The ACA provided certain risk spreading mechanisms commonly referred to as the "Three R's" (risk adjustment, reinsurance and risk corridors) to limit a CO-OP's potential losses by participating in the marketplace. However, recent legislation such as the American Taxpayer Relief Act of 2014 and the Consolidated and Further Continuing Appropriations Act of 2015 rescinded certain CO-OP loan program appropriations, prohibited loans to new ACA program participants and failed to allocate certain additional risk corridor benefit payments necessary to keep many ACA qualified health plans solvent. Moreover, unlike other private insurers, CO-OPs are precluded from selling stock to raise capital and are often unable to find alternative sources for capital infusions. As a result, numerous CO-OP programs created under the ACA have either failed or are in jeopardy of failing as they are unable to meet cash flow demands and satisfy state solvency requirements.

Under the McCarran-Ferguson Act, insurance companies are exempt from most federal regulations. As a result, entire bodies of federal law, including bankruptcy, are generally inapplicable to the insurance industry, and state regulatory agencies are responsible for overseeing insurance activities within their state. Such agencies are empowered under applicable state laws to place financially troubled insurance companies into court-supervised rehabilitation or liquidation proceedings. In New Jersey, this process has been codified through the Life and Health Insurers Rehabilitation and Liquidation Act (NJ R&L Act).

Rehabilitation and liquidation proceedings are similar to bankruptcy proceedings. Typically, the state insurance commissioner (or their deputy) serves in a capacity similar to a bankruptcy trustee or debtor in possession, overseeing the rehabilitation or liquidation of the insurance company. By way of comparison, a rehabilitation proceeding is akin to a Chapter 11 bankruptcy reorganization, while a liquidation proceeding is akin to a Chapter 7 bankruptcy liquidation.

Once a rehabilitation or liquidation order is entered by the Court, the insurer in its corporate form prior to the order ceases to exist and a new entity, overseen by the Rehabilitator and/or Liquidator, is created. All of the assets of the former entity are transferred to the Rehabilitator/Liquidator, who is granted extensive powers over the insurer's assets and the operation or winding down of the new entity. Such rehabilitation and/or liquidation efforts should be of immediate concern to landlords, as the space needs of the insurer tenant will likely be reduced or eliminated as part of the rehabilitation/rehabilitation process.

Notably, the NJ R&L Act expressly protects the entity in rehabilitation/liquidation from any claim of anticipatory breach of any contract to which the insurer is a party. Therefore, landlords may not declare a breach of the lease upon the entry of a rehabilitation and/or liquidation order. By contrast, the Rehabilitator/Liquidator is expressly empowered to cancel, reform or revoke any contract to which the insurer is a party, including leases. As the business judgment of a Rehabilitator/Liquidator is generally respected by courts, motions to reject or reform leases are frequently granted.

Based on the foregoing, it is critical for landlords to closely monitor reforms to the ACA as a means of determining whether they could adversely impact the financial standing of any tenants. Through proper drafting and monitoring, a landlord can attempt to proactively address leasing concerns in lieu of having the lease subject to the judicial process and potential reformation and/or termination under the NJ R&L Act. Moreover, should an insurer tenant seek rehabilitation or liquidation under the NJ R&L Act, it is important that the landlord consult with a legal advisor who has the experience and expertise to guide them through the rehabilitation/liquidation process and promptly engage the Rehabilitator/Liquidator in negotiations in order to attempt to resolve any potential leasing disputes.

"Problem Loans" and the Commercial Real Estate Capital Markets in 2017

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Much has been written in commercial real estate (CRE) industry publications about the impending tsunami of "problem loans" maturing in 2017. Commercial mortgage-backed securities (CMBS) loans generally have a ten-year life span, at which point they need to be refinanced, and 2007 was a busy year for the CMBS market. Property values were at their peak and credit underwriting was aggressive. As a result, in 2017 we are facing a "wall of maturities" with, by industry estimates, approximately $200 billion in CMBS loans due to mature by the end of this year. In addition, many of the existing loans are interest-only and were underwritten at higher loan-to-value ratios than are currently available. Since 2007, CRE lenders, including CMBS lenders, face new regulatory requirements such as higher capital reserve requirements and risk retention rules. Stricter credit underwriting standards are also now the rule in the industry. Will this volume of CRE mortgage loans seeking refinancing crash the CRE capital markets this year?

2016 experienced a comparably high volume of loan maturities, but no refinancing crisis materialized. Although some properties were forced to be sold as "short sales," many were successfully refinanced at maturity. Interest rates were at historic lows and that helped. Additionally, the values of many collateral properties have returned to pre-Great Recession levels so that even at lower loan-to-value ratios, borrowers have been able to close the gap between the loans maturing and the funds available from refinancing. Those borrowers who could not contribute additional equity to their properties turned to a growing field of preferred equity investors to fund the shortfall. All of that was supplemented last year by a wide variety of lenders in the market with money to deploy. Traditional bank lenders and insurance

company lenders increased CRE loan originations in 2016 over 2015. Non-traditional lenders such as real estate debt funds also played a growing role. In addition, the volume of CMBS loans last year remained strong.

The key factor in determining whether a CRE loan can be successfully refinanced is the type and quality of the collateral property. Not all types of CRE properties have fared equally since the recovery from the Great Recession. In New Jersey, most notably, industrial warehouse properties have recently enjoyed several banner years. The state's proximity to large population centers has made New Jersey (particularly the I-95 corridor and the Port Newark/Port Elizabeth area) ideal for modern supply chain distribution centers and consumer overnight delivery terminals. Those well-situated industrial properties have experienced low tenant vacancy and strong leasing activity and have appreciated in value dramatically over the last few years. Even decreased loan-to-value ratios have not diminished their refinancing potential.

Likewise, multi-family housing has been in great demand by investors and lenders alike in recent years. Although this trend is likely to continue, for the most part, through 2017, there is speculation that the high-end of this segment, luxury urban rentals, may be overbuilt and that market demand for them will soften. Moderately priced Class B apartments may enjoy higher demand. The "financeability" of any particular multi-family property will depend on its current and projected occupancy levels, which, in turn, will depend on location, amenities and rental rates.

Office properties in New Jersey are more of a mixed bag and again, location is key. The Class A office buildings in highly-desirable locations like Jersey City, Short Hills and Metropark do not share the fate of office buildings in less desirable locations such as Parsippany or Piscataway. The former have enjoyed one of the strongest years for office leasing in some time. As a result, values have appreciated and refinancing has not generally been a problem. However, if lenders believe that 2016-2017 represents the peak of this economic cycle, office properties will face higher hurdles to refinancing since office properties generally underperform other CRE segments in a downturn.

Farther down the ladder of properties with good refinancing prospects are hotel properties. Revenues in the hotel sector tend to fall the fastest and furthest in an economic downturn. The sentiment in that sector is that hotels have peaked, making 2017 a potentially tough year for financing hotel properties.

Even more troubling are the prospects of retail properties, which have not shared in the general market recovery of the last few years to the same extent as other types of commercial properties. The brick-and-mortar retail industry is the victim of changing consumer shopping habits, with online sales continuing to grow each year and in-store sales declining by matching levels. The one portion of the retail sector that does enjoy better prospects in the debt markets is grocery-anchored neighborhood strip malls, which will continue to attract debt capital in 2017.

Notwithstanding lower leverage ratios and stricter underwriting, a crisis in "problem loans" was avoided last year and most expect that it will be averted again this year. In 2017, however, borrowers should expect stricter underwriting and credit standards, higher interest rates and continued lower loan-to-value ratios.

Additionally, the type and quality of the CRE collateral will be paramount to a successful refinancing.

Mortgage Foreclosure Reform: The Impact on the Collection of Assessments in Common Interest Communities

Christine F. Li, Partner

One of the most important aspects of our community association law practice is the pursuit of delinquent common expense assessments. Without the timely funding of regular and special assessments, the associations governing condominiums and other planned communities are incapable of maintaining the level of services and sustaining the quality of life to which their residents are entitled.

The challenge of pursuing payment of delinquent common expense assessments is heightened by the fact that unpaid common expense assessments are subordinate to payments due under the lien of most recorded mortgages. The only exception is the “super lien” equivalent to the aggregate customary condominium assessment for the six-month period prior to the recording of the community association’s lien for unpaid assessments. This limited priority is allowed to condominium associations pursuant to the New Jersey Condominium Act. In a nutshell, upon the foreclosure of a mortgage by a lender, a condominium association will receive a payment representing six months of the amount of the association’s regular common expense assessment.

To compound the problems faced by associations, during 2016 New Jersey had the dubious honor of topping the list of states in “zombie foreclosures,” an expression which is apt shorthand for residential properties that mortgage borrowers have vacated, and upon which the foreclosure process was never completed.

Recently adopted statutes evidence the importance of ensuring that collection efforts on behalf of a community association are conducted with knowledge of recent statutes reforming mortgage foreclosure practice. The interrelationship between laws governing the foreclosure of mortgage loans by lenders and the implementation of those laws in the collection of common expense assessments by community associations is essential.

In 2014, New Jersey adopted legislation authorizing foreclosing lenders to conduct an expedited summary action to foreclose mortgages encumbering “vacant and abandoned” properties. Under the law, the mortgagee is required to demonstrate, by clear and convincing evidence, that the mortgaged real estate is vacant and has been abandoned, or that a notice of violation has been issued. The statute delineates fifteen indicia of abandonment and the mortgagee is required to prove that two such conditions exist.

Further legislation was passed in 2016 authorizing municipalities to adopt ordinances to require a creditor commencing an action to foreclose a residential property to be responsible for the care, maintenance, security, and upkeep of the exterior of the vacant and abandoned residential property. Under the law,

municipalities must first adopt an ordinance before mortgagees can be compelled to perform such maintenance. Municipalities that have adopted ordinances authorizing such maintenance of properties in foreclosure include Howell, Bergenfield, Hightstown, Linwood, Ringwood and Evesham. Maintenance that a municipality may require to be performed under the ordinance is limited to the exterior of the vacant and abandoned property.

If the foreclosing creditor is located out-of-state, the mortgagee is required to appoint an in-state representative or agent to act for the foreclosing mortgagee. If the foreclosing mortgagee violates the requirement to appoint an in-state representative or agent, the mortgagee shall be subject to a fine of $2,500 for each day of the violation. If a municipal court, or other court of competent jurisdiction, finds that a mortgagee is in violation of the requirement to correct a care, maintenance, security or upkeep violation, the mortgagee will be subject to a fine of $1,500 for each day of the violation. The imposition of fines commences 31 days after the mortgagee receives notice, except if the violation presents an imminent risk to public health and safety. In such case, any fines shall commence eleven days following receipt of notice.

As of this writing, Senate Bill No. 1832 (with an identical Assembly Bill A3823) has been introduced to legislatively revise the existing expedited process of mortgagees to foreclose vacant and abandoned residential properties to enhance the remedies available to common interest communities with respect to such.

This amended bill strengthens the remedies available to common interest communities so that, when a lender is entitled to proceed through the expedited foreclosure process but has not done so, the board of the common interest community may make a motion to compel the mortgagee to pay association fees. The court may either enter an order compelling the lender to pay to the common interest community the association fees or, alternatively, approve an application for the appointment of a fiscal agent. The fiscal agent would be responsible for maintaining the property and paying association fees and assessments for benefits such as utilities, common element expenses, amortization of common elements, administrative costs, and maintenance of the physical structure in order to protect, preserve, and maintain the property for the benefit of the entire community.

As we move through 2017, we will continue to provide timely updates on statutory and legislative developments impacting community associations.

The ABC's of New Jersey's Bulk Sales Tax Statute: Notification Requirements and Exemptions

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The purchaser of a business asset located within the State of New Jersey is required to notify the New Jersey Division of Taxation at least ten business days prior to the purchase and sale of that asset in order to avoid possible exposure to the tax liabilities of the seller. Within ten business days from receipt of such notification, the Division of Taxation must notify the purchaser's attorney in writing whether any funds are to be escrowed from the seller's closing proceeds, or whether the transaction is cleared to close without an escrow.

Over the years, the Division of Taxation has clarified that notification is not required if the business asset is sold in the seller's ordinary course of business, such as the sale of new homes by a real estate developer. Also exempt is a foreclosure of real property by Sheriff's or Marshall's deed and a sale of stock or membership interests by an individual. However, a transaction involving a deed in lieu of foreclosure is subject to the notification requirement.

In order to address concerns raised by the legal profession and the real estate business community that the notification requirement was overly burdensome and unnecessarily complicated in some cases, New Jersey's bulk sales tax statute was amended to exempt certain transactions.

Specifically, the sale, transfer or assignment of a "simple dwelling house" is exempt if the seller is an individual (defined as a single individual, married or civil union couple), an estate or trust. "Simple dwelling house" is defined as a dwelling unit, attached or detached, and land appurtenant thereto, including but not limited to a one or two family building or structure, a unit in a housing cooperative, or a condominium unit.

Also exempt is the sale, transfer or assignment of a "seasonal rental unit" or a "lease for a seasonal use or rental of real property" if the seller is an individual (as defined above), an estate or trust. "Seasonal rental unit" is defined as (i) a timeshare estate and (ii) a dwelling unit rented for not more than 125 consecutive days for residential purposes by a person having a permanent residence elsewhere. A "lease for seasonal use or rental of real property" means (i) a timeshare use and (ii) the use or rental for not more than 125 consecutive days for residential purposes by a person having a permanent place of residence elsewhere.

The foregoing exemptions and clarifications to the notification requirements have provided some needed clarity and predictability to many transactions and have limited the previously expansive reach of the bulk sales tax statute. Nevertheless, given the possible costly consequences that may result from a mistaken failure to provide notification to the Division of Taxation, legal advice should be sought any time the purchase of a business asset is contemplated in New Jersey.

Ensuring Compliance with Parking Requirements Necessitates Careful Due Diligence

John H. Hague, Partner

An often overlooked but potentially critical area of due diligence upon the acquisition of an existing improved property is the compliance of parking with ordinance requirements with regard to design, ratios to identify the required count of spaces, size of spaces, landscape and setbacks. Given the numerous municipal jurisdictions in New Jersey, each with its own requirements and enforcement methods, there is no uniformity with respect to these issues.

A reliable inquiry needs to go beyond the question of whether a Certificate of Occupancy had been issued for the existing or a prior use of the property. Some municipalities take a more aggressive approach to their parking requirements, possibly even requiring a site plan waiver review when occupancy changes to ensure compliance with parking ordinances. Although most municipalities take a more laissez-faire approach, the prospective purchaser should not be lulled into complacency by this, as they will be proceeding at the risk of future enforcement in the event of deficiencies. This can arise when a new use results in insufficient parking and parking spills over to adjoining streets and properties, resulting in a citizens' call for "action" to solve the problem.

The primary issue is that different categories of permitted use may have different ratios of required parking, typically tied to the area of the building. The ratios may also be tied to employee counts (such as in a manufacturing facility) or seat counts (which might be found in a restaurant or religious facility). There is also the problem of categories of use found in existing ordinances that have not been brought current, and that have evolved due to changing technology and business practices, which is more often than not the reality. Another significant area of concern is restrictions on parking that may have been imposed as a result of zoning variances granted in connection with the development of a property that may tie parking design or ratios to a specific use. Finally, there is the circumstance of parking rendered non-conforming by a change in ordinance requirements after initial construction.

By way of example, a typical problem may arise in the conversion of space with a low parking ratio such as a warehouse, to a use with a more restrictive ratio such as office, laboratory or manufacturing. If the warehouse requirement is one space per 1,000 s.f. and the manufacturing requirement is one space for 250 s.f., there may not be enough surface parking on a built-out property for which conversion of use is contemplated.

An example of an evolving use due to technology and changing practice is the modern distribution-type facility with robotics to handle storage, selection, packaging and shipping of goods. Is such a facility a warehouse with a low ratio or a light industrial use with a more restrictive ratio? Where the ordinance does not draw a clear distinction as to how a use should be categorized, it may be necessary to take advantage of a feature of New Jersey's Municipal Land Use Law that puts the burden of determination on the municipal zoning officer in the form of the issuance of a zoning permit. If the zoning officer is unwilling

to issue a zoning permit to confirm a favorable interpretation of use, then the next recourse is to the zoning board of adjustment for interpretation of the ordinance, and possibly a variance if the interpretation is unfavorable.

It is important to evaluate prior approvals to determine if there are conditions attached to parking requirements. An Open Public Records Act inquiry can be made of the municipality's land use offices to identify and obtain resolutions memorializing approvals. An example of such a condition would be the approval of a less-restrictive ratio in favor of a specific medical use, provided that the use continues. Thus, a change of use to a different medical use or professional office use would require a trip back to the planning board or board of adjustment for approval of parking as it relates to the new substitute use.

A final area for consideration is a situation where parking ratios, parking stall size, or some other design feature do not conform to current ordinance requirements that were established prior to the existing ordinances. In such circumstances, the parking would be considered lawfully nonconforming, but that could tie parking to the use in place at the time the nonconformity arose due to the adoption of an inconsistent ordinance. Again, variances might be needed to support a change in use.

The conclusion one should draw from these concerns is that parking due diligence should not be undertaken superficially. Thorough due diligence will avoid future determinations by municipal officials that a property is out of compliance with parking ordinance requirements and enforcement actions such as rescission of a Certificate of Occupancy, to say nothing of the potential for breach of covenants in financial documents as to zoning compliance.

NJ Supreme Court to Decide the Validity of Attorneys Disapproving Residential Sales Contracts

Barry S. Goodman, Partner

On January 17, 2017, I argued before the New Jersey Supreme Court in my role as General Counsel for the New Jersey REALTORS® in a matter challenging what has become the customary practice of real estate attorneys in New Jersey to send brokers, by fax or email, a notice of disapproval of a residential real estate sales contract prepared by a broker. This practice is at odds with the Court's mandated methods of delivery of the notice and therefore calls into question whether or not those notices of disapproval are valid, or whether the sales contracts remain in full force and effect.

By way of background, the right of buyers and sellers of residential real estate to have an attorney review a sales contract prepared by a real estate licensee was created as a result of a lawsuit brought by the New Jersey State Bar Association against what was then known as the New Jersey Board of REALTORS®. The lawsuit, which alleged that real estate licensees preparing contracts for buyers and sellers constituted the unauthorized practice of law, was settled. However, the New Jersey Supreme Court had to approve the settlement because the Court has sole jurisdiction over the practice of law (and therefore the unauthorized

practice of law in New Jersey).

In 1983, the Court approved the settlement, giving buyers and sellers the right to have three business days to consult an attorney in exchange for a real estate licensee who has a fee or commission interest in a real estate transaction being able to prepare a residential sales contract for the sale of either one-to-four dwelling units or vacant one-to-four family lots, or a lease of one year or more. Under attorney review, an attorney can disapprove the contract for any reason (or no reason at all) by sending a notice of the disapproval to the other party, and by also sending the notice of disapproval "to the Broker(s) **by certified mail, telegram, or by delivering it personally.**" Courts consistently have held that all of the provisions of the attorney-review provision must be strictly complied with in order for there to be an effective notice of disapproval.

In the case now before the Supreme Court, *Conley v. Guerrero*, a real estate licensee prepared the sales contract for the sale of a condominium. During the three business days that the parties had to consult an attorney, the seller received much higher offers for the condominium. As a result, the seller's attorney sent a notice of disapproval within the three business days to the buyers' attorney and to the broker **by fax and email**, which has become the custom in the real estate industry notwithstanding the requirement to send notice to the brokers by certified mail, telegram or personal delivery.

The buyers' attorney rejected the notice of disapproval and claimed that the contract was valid because the seller's attorney had not complied with the specific terms of attorney review. The trial court and the Appellate Division held that the notice was effective because there had been substantial compliance with the attorney-review delivery requirement, especially since the broker had actual knowledge of the disapproval and was not complaining about it.

The issues before the Supreme Court were whether or not (1) the disapproval in this case was valid, (2) the Court should update the methods by which an attorney can send the notice of disapproval to the broker and, (3) if the Court updates the delivery methods, the updated methods should be applied retroactively to the literally thousands of transactions in which attorneys have sent the notice by fax or email.

On behalf of the New Jersey REALTORS®, I argued that the Court should update the methods of delivery to include fax, email and reputable overnight courier, and should delete notice by telegram, which is no longer available even though it was a viable means of delivery in 1983. I also argued that if the methods of delivery are updated, the decision should be applied retroactively in order to create certainty for all the buyers and sellers whose transactions might be affected by an attorney having sent the notice of disapproval by fax, email or overnight courier.

The Court's decision will not only impact residential real estate transactions going forward but, assuming that the Court updates the methods of delivery for the notice of disapproval to include email, fax and overnight courier, may affect at least pending transactions in which an attorney for the buyer or seller sent a notice of disapproval by a means other than certified mail, telegram or personal delivery.

Environmental Insurance in Brownfields Development: A Hypothetical Case Study

Ann M. Waeger, Partner

Heading into 2017, real estate developers continue to be challenged in the quest for large tracts of clean land in desirable locations, particularly in the residential setting. As a result, "brownfield" properties with a range of environmental impacts – from minor to significant – remain attractive to purchasers who are willing to take on the risks associated with both remediating and developing these properties with the hope of reaping an ultimate economic reward at the end of the project.

One risk management tool that will often help not only the developer, but also their investors and lenders who envision the pot of gold at the end of the rainbow, is environmental liability insurance. The market for these policies continues to be robust, and we worked closely with a number of clients who purchased environmental insurance in 2016 to help manage risk. Here is a hypothetical example based upon our experiences in the representation of clients involved in several different projects.

In our scenario, the sellers were able to produce environmental signoffs from governmental agencies on a brownfield property. The due diligence conducted by the purchasers, however, found significant environmental issues that had not been discovered previously – and the sellers lacked both the inclination and the financial resources to take on the risk. As a result, the purchaser was forced to decide whether or not to proceed. In this example, before closing, the purchasers performed additional investigations to get their arms around the potential risks and costs. They ultimately made the decision to move forward with the transaction, provided they could obtain an environmental insurance policy to help manage certain risks.

The critical aspects of the insurance they sought included bodily injury and property damage coverage for both known and unknown pre-existing and new pollution conditions, cleanup cost coverage for known pollution conditions (after receiving final governmental signoff) resulting from a change in cleanup standards in the future, as well as unknown pollution conditions that might be discovered during the course of performing a cleanup or constructing a development.

While an "innocent" insured that conducts appropriate and comprehensive environmental due diligence can in most instances purchase a policy that includes (subject to policy terms and conditions) coverage for bodily injury and property damage for both pre-existing and new pollution conditions and the cleanup of new pollution conditions, insurers tend to be reluctant to take on the cleanup risks for known pollution conditions (unless the government has signed off on the cleanup of those conditions) or unknown conditions that may be unexpectedly discovered during remediation or development.

By working with experienced environmental insurance brokers and our clients' environmental teams, a package of documentation was compiled and presented to the insurance company that told the true environmental story of the site. We carefully negotiated certain key policy terms needed to help the policy

fit the deal. In the end, our clients were able to obtain the coverage they sought to assist in managing certain environmental risks, and in turn satisfy their lenders and investors in order to successfully close the deal.

The Personal Guaranty: The Forgotten Lease Negotiation?

Steven C. Delinko, Partner

In the practice of commercial real estate leasing, the concept of securing, collateralizing and guarantying the tenant's performance of the terms and conditions of a lease is fundamental to the lease transaction. The landlord needs to be assured that the terms and conditions of the lease will be performed and complied with by the tenant, especially the monetary obligations of the tenant. Failing that, the landlord needs to have readily available means to address the tenant's failure or default. An adequate security deposit, and in many cases, additionally, a personal guaranty from either the principals of the tenant or a credit-worthy person or entity (usually related to the tenant) guarantying the performance of the tenant becomes a condition precedent to the consummation of the lease.

The personal guaranty can take various forms. With a "full-blown personal guaranty," the guarantor unconditionally obligates itself to the payment and performance of the obligations of the tenant under the lease. A "limited personal guaranty" terminates the guarantor's obligations to pay and perform the obligations of the tenant under the lease sometime short of the expiration of the term of the lease. With a "rolling personal guaranty," the guarantor guaranties the payment and performance of the tenant under the lease for a fixed period of time following the default of the tenant. Another type of personal guaranty is known as the "Good Guy Guaranty."

The Good Guy Guaranty can take many different forms, however in essence it requires that the guarantor be liable for all the terms, covenants and conditions to be performed by the tenant under the lease, but allows the guarantor to be released from its obligations to the extent the tenant: 1) notifies the landlord in advance of its desire to vacate and surrender the property; 2) actually vacates and surrenders possession of the property to the landlord in accordance with the terms and conditions required under the lease; and 3) continues to be responsible for the payment of rent and performance of tenant's obligations until surrender or for a period of time after surrender.

The Good Guy Guaranty is attractive to the landlord because instead of spending time and money in litigation against the tenant to obtain possession of the property, the landlord obtains legal possession of the property directly from the tenant, and thereafter still maintains its claim against the tenant (for the payment of the rent and the performance of the other terms and conditions of the lease until the expiration of the term of the lease) ***and*** the guarantor (until surrender or for a period of time after surrender). The Good Guy Guaranty is attractive to the guarantor because it lessens the guarantor's obligations by allowing the guarantor to be relieved of its obligations at some time short of the full term of

the lease, provided the property is properly and timely surrendered to the landlord.

Recently, the firm has been involved in a number of situations where the personal guaranty was brought into play – to a greater or lesser degree depending upon the actual form of guaranty – as previously described. In one instance, we represented the owner of a shopping center where the operator of one of its retail store tenants had personally guaranteed the lease. The operator had aged and after taking ill, needed to sell his business and move to Florida. The operator found a buyer for its business that met the assignment conditions of the lease. The operator requested the landlord release him from his personal guaranty and in exchange, have the new buyer/operator substitute its personal guaranty for the existing guaranty, as the operator certainly didn't want to continue to guaranty a lease in which he no longer had an interest. The lease and guaranty were silent.

In another situation, we represented an operator-tenant of several exercise facilities who decided to franchise its operations. The operator and his wife had personally guaranteed the lease at one of the locations proposed to be sold as a franchise. The operator-tenant presented an experienced, creditworthy buyer who satisfied the assignment conditions of the lease. The lease was silent as to a termination or substitution of the personal guaranty. We are now awaiting the landlord's response to our client's request to be released from the personal guaranty in exchange for a mirrored, substitute personal guaranty from the principal in the buyer of the franchise.

In a somewhat different scenario, we represented an office tenant who had changed its business model and no longer required space in a particular office building in Manhattan. A creditworthy parent corporation had guaranteed the lease. Once again, lease and guaranty were silent as to a termination or substitution of the personal guaranty. Our client presented creditworthy assignees and substitute guarantors, however the landlord would not agree to release the existing guarantor and terminate the guaranty.

Although hindsight is "always 20/20," the above situations could have been avoided had the issues been addressed at the initial negotiation of the respective leases. The tenants could have included in their negotiations a provision where, in connection with the sale of substantially all of the stock or assets of the business entity on the lease, the personal guaranty would be terminated and the original guarantor released of further liability upon presentation of a substitute guaranty mirroring, in form and content, the existing guaranty from a person or entity with reputation, experience and net worth at least equal to that of the original guarantor of the lease, as reasonably determined by the landlord.

In the context of negotiating a right to assign the lease as a result of the sale of substantially all of the stock or assets of the business entity on the lease, landlords are usually agreeable to permitting the assignment and releasing the tenant. As long as the landlord believes it is being reasonably protected, the similar negotiation of the personal guaranty should be equally favorably received. The problem, in our experience, is that the negotiation of the personal guaranty is usually overlooked or not given proper attention or priority during the initial negotiation of the lease. The opportunity may exist, however, to address this issue as leases are renegotiated and renewed.

Lien Priority of Mortgages: What You Don't Know May Hurt You

Kenneth T. Bills, Partner

While the general rule that a mortgage when properly recorded and indexed in the land records has priority over a mortgage that is subsequently recorded against the same property may seem simple, the question of mortgage priority often becomes more complex. A 2016 case before the Supreme Court of New Jersey examined the complications that arise when the earlier mortgage secures future advances.

The Court's ruling in *Rosenthal & Rosenthal, Inc. v Benun* reinforces that particularly in instances when the same property secures more than one mortgage, a careful legal analysis of the terms of the mortgage can be critical in assessing which one will have priority.

Vanessa Benun had guaranteed the obligations of two of her father's companies under "factoring" (account receivable financing) agreements the companies (as borrowers) had entered into with Rosenthal & Rosenthal, Inc. Benun secured the guaranties with mortgages against real estate she owned in Monmouth County. Each mortgage provided that it would secure future advances made by Rosenthal under the factoring agreements, up to a maximum amount of $1,000,000 per mortgage.

Two years later, Benun granted a third mortgage on her Monmouth County property. This mortgage was given to secure over $1,500,000 in legal fees her father (and his businesses) owed to the law firm of Riker, Danzig, Scherer, Hyland & Peretti, LLP. In return for the mortgage, Riker agreed to continue providing legal services to Benun's father and his businesses.

Over the next two years, Rosenthal continued to advance money under its factoring agreements, and Riker continued to perform legal services for the businesses. When the borrowers subsequently defaulted under the factoring agreements, Rosenthal was owed in excess of $4,000,000. Meanwhile, Riker was now owed in excess of $3,000,000 in legal fees, and Benun was bankrupt. The property she had mortgaged to Rosenthal and Riker was worth far less than the combined $7,000,000 secured by their mortgages.

Rosenthal began a foreclosure action, relying on the principle of "first in time, first in right" to contend that its mortgages had priority over the subsequent mortgage to Riker. Rosenthal emphasized that Riker had actual knowledge of the existence of the Rosenthal mortgages when its mortgage was obtained. In fact, the Rosenthal mortgages specifically prohibited Benun from granting any other mortgages on her property in a so-called "anti-subordination clause." The trial court agreed with Rosenthal.

On appeal, the Appellate Division reversed, and in its *Rosenthal* decision, the Supreme Court affirmed that reversal. Relying in part on New Jersey's mortgage priority statute, which provides protection for future advances of principal only when the lender is obligated to make those advances under a "line of credit" mortgage, the Supreme Court reaffirmed the common-law distinction between obligatory and optional advances. Under the common law, future advances are subordinate to a subsequent mortgage unless they

are mandatory or the lender making the advance has no actual knowledge of the subsequent mortgage. While prior court decisions have modified the common law rule to provide that the constructive notice resulting from the mere recording of a second mortgage is sufficient notice to give the second mortgage priority over future construction advances, for all other future advance mortgages, actual knowledge continues to be required.

Rosenthal's advances under its factoring agreements were discretionary, and unfortunately for Rosenthal, an email from its counsel written before the advances were made demonstrated that Rosenthal had actual knowledge of the Riker mortgage. Accordingly, Riker's second mortgage took priority over Rosenthal's first mortgage, notwithstanding that the principal amounts of both mortgages were increasing over the same period of time, and that both Riker and Rosenthal had actual knowledge of the other's mortgage.

The Supreme Court's decision leaves the maker of a future advance mortgage in a strange position. If the lender checks the land records for second mortgages and finds one, the lender has actual knowledge and any discretionary advance later made is subordinated to the second mortgage. If the future advance lender closes its eyes and does not check the land records, any discretionary advance will have priority over any recorded subordinate mortgage (unless the holder of the subordinate mortgage can later prove that the future advance lender had actual knowledge).

Similarly, a lender accepting a second mortgage as security needs to examine the first mortgage, and if it secures discretionary future advances, must either provide actual notice to the first mortgagee or risk being subject to discretionary future advances, since merely recording its mortgage will not protect its priority against those advances. Further risks arise because there is no bright line rule on how actual notice can be obtained – for example, would telephone notice to a loan officer suffice? As even the distinction between mandatory and discretionary advances is not always clear, both future advance lenders and holders of second mortgages face significant uncertainty. This case serves as a reminder that securing future obligations and loans by a mortgage can be a tricky business that requires legal guidance.

Following Recent Supreme Court Ruling, Affordable Housing Determinations Should Proceed … Slowly

Steven Firkser, Counsel

Two years after the Supreme Court of New Jersey ordered the state's trial courts to establish a process to determine the affordable housing obligations in New Jersey's 565 municipalities, slow progress has resulted in a handful of determinations. In 2015, the Court determined that the Council on Affordable Housing (COAH) had failed in its responsibilities to ensure the construction of housing affordable to low- and moderate-income households, and required the trial courts in each county to make these determinations. More than 375 municipalities filed declaratory judgment actions for the courts to determine their affordable housing obligations.

Since the 2015 decision, the *Mount Laurel* judges have started to proceed with trials to determine the municipal obligations, but there have been few decisions fixing the numbers. The municipalities and housing advocates have retained experts, and the numbers produced by those experts are widely disparate. Most of the judges have appointed their own independent experts to determine the obligations that each municipality must achieve.

One major obstacle has been determining the scope of the obligation. There are three components of the obligation: (1) a prior unmet need for housing that was not constructed as of 1999, (2) a present need to cover deficient housing units as of 2015, and (3) a prospective need to cover housing needs over the next ten years (2015 – 2025). All parties generally agree on the outstanding obligations for housing as of 1999, but the parties have vastly different opinions on the obligations after that. Housing advocates believe the calculation of present need should include housing needs from 1999 to 2015, while the municipalities claim the present need should be determined as of 2015. The determination as to whether there is a separate obligation for this 1999-2015 'gap period' has now been decided by the Supreme Court of New Jersey.

In a January 18, 2017 decision, the Supreme Court struck a middle ground between the positions of housing advocates and municipalities and held that the trial courts must use an expanded category of present need in order to capture pent-up housing needs that arose between 1999 and 2015. The court held that the present need must include, in addition to a calculation of overcrowded and deficient housing units, an analytic component that addresses the affordable housing need of low- and moderate-income households created since 1999. The recalculated obligation should not include households that are no longer income-eligible, deceased persons or households already captured through the historic practice of assessing deficient housing units within the municipality. The Supreme Court did not provide much more guidance, and the planners for the municipalities and housing advocates will need to update their expert reports to address the expanded category of present need.

Many judges were awaiting the Supreme Court decision before proceeding to trial, and they will now be scheduling trials. Some judges, notably in Middlesex County, have proceeded in cases involving individual municipalities, but most courts are pursuing a consolidated trial involving all municipalities in their county. In one trial completed last year, South Brunswick was ordered to comply with the very high number presented by the housing advocates.

In order to provide some certainty, more than 90 towns have settled with housing advocates and have agreed on the obligations that must be satisfied. For the other 200+ towns, they will be awaiting trials later this year that will hopefully yield decisions that fix the municipal obligations.

The general consensus is that the new Supreme Court opinion will result in an increase in the calculation of housing needs, but factually this will be addressed on a case-by-case basis. As municipalities must now revise their present need obligations to capture additional households created between 1999 and 2015, this could provide an opportunity for developers who can offer affordable housing developments to assist the municipalities in meeting their obligations. Further, when municipalities present their housing plans,

interested developers will also have the opportunity to contest the validity of those plans and seek to include their properties with an affordable housing component.

New Jersey Public Financing & Incentive Programs: What Developers Should Know

Steven G. Mlenak, Associate

The New Jersey Economic Development Authority (EDA) offers several public financing and incentive programs established by the state Legislature. When planning a new project, developers and businesses should be familiar with some of the more beneficial programs that are now available.

Real Estate Impact Fund (REIF) – This program provides financial support of up to $3 million to developers in strategic urban and other significant locations where development would not otherwise occur in the near term. Just this past December, the EDA approved an expansion of the REIF to provide up to $750,000 in low-interest financing to Urban Aid municipalities and eligible local redevelopment agencies or county improvement authorities, a helpful tool for developers partnering with such public bodies to develop land owned by the public.

Grow New Jersey Assistance Program (Grow NJ) – Administered by the EDA, Grow NJ provides tax credits of up to $15,000 per job/per year to qualified businesses that make, acquire or lease qualified capital investments in facilities that either create or preserve jobs in a qualified incentive area. The program was established to encourage job creation and to preserve existing jobs that are in danger of being relocated outside of the state. It provides economic support to businesses looking to relocate to or remain in New Jersey, as well as to commercial landlords seeking to attract those businesses.

Economic Redevelopment and Growth Program (ERG) – This program is also administered by the EDA, providing incentives to developers and businesses to address revenue gaps in development projects. Revenue gaps are defined as having insufficient revenues to support the project debt service under a standard financing scenario. The ERG can also apply to projects with a below market development margin or rate of return.

Environmental Programs – The EDA administers several environmental incentive programs. Both the Hazardous Discharge Site Remediation Fund (HDSRF) and the Brownfields and Contaminated Site Remediation Program provide secure financing through loans and/or grants for businesses required to, or volunteered to, perform remediation and/or cleanup of contaminated and underutilized sites. Meanwhile, the Municipal Landfill Closure and Remediation Reimbursement Program provides eligible developers with up to 75% of the closure or cleanup costs associated with the remediation and redevelopment of a municipal solid waste landfill.

New Jersey also provides various incentive opportunities for developers partnering with public agencies. In such situations, municipalities are typically willing to provide exemptions to the (re)developer from property taxes in exchange for payments in lieu of taxes (PILOT) for up to 35 years. Other financing options that are sometimes a possibility include low-interest general obligation, revenue backed, or redevelopment area bonds, as well as EDA or municipal loans or grants.

It should be noted that by accepting public financing or other incentives, the developer will usually be required to comply with various hiring and reporting requirements. Further, under many of these programs, the developer would also be required to pay Prevailing Wages to its contractors and subcontractors. For this reason, developers are urged to perform a cost-benefit analysis with an experienced real estate and redevelopment attorney prior to applying for, and accepting, one or more of the programs discussed above.