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COMMERCIAL REAL ESTATE ALERT

JANUARY 2003
ADDRESSING THE NEEDS OF COMMERCIAL REAL ESTATE PROFESSIONALS

Subleasing:
The Sublandlord's Perspective

BY SCOTT W. SINGER, ESQ

THIS ARTICLE IS THE THIRD in a series of three that addresses the subject of subleasing from the Master Landlord, Sublandlord and Subtenant perspectives. To obtain copies of the prior articles, please visit our web site at *www.berding-weil.com*, where the prior versions of the Commercial ALERT are available in downloadable .pdf format.

The decision of the Sublandlord to enter into a Sublease is more of a business decision than a function of the format of the Sublease document. The Sublandlord will remain primarily liable for any default of the Master Lease. Therefore, while this article is somewhat less legal analysis intensive, hopefully it will provide the reader with some of the practical and legal issues that arise in a Sublease from the Sublandlord's perspective. The following portions of the Sublease document and Master Landlord Consent are worth close examination.

1. Landlord's Consent.

Almost all commercial leases provide that a Sublandlord must seek the consent of the Master Landlord before entering into a Sublease transaction. Generally, the Master Landlord's consent cannot be unreasonably withheld. Often times the Lease document will have certain delineated criteria which justify the Master Landlord withholding its

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Surety Bonds
Protection for the Owner Before the Work Starts[1]

BY: DANIEL L. ROTTINGHAUS, ESQ.

PROPERTY OWNERS AND ASSET MANAGERS need to be familiar with surety bonds, how to use them and the process of obtaining them. Those who are familiar with them and how they work know how useful surety bonds can be in *reducing risk* and keeping owner control over a work of improvement. Those who are not familiar with them, however, are missing a great opportunity *before the work even starts* to protect themselves, their company and their shareholders from the tremendous costs involved when a contractor fails to meet its contractual obligations.

Unlike insurance policies, surety bonds create legal relationships before the work commences and these relationships remain viable throughout the construction process. The relationships established by a surety bond protect the property owner (and the property owner's project) in a manner that is far different from insurance protection. Whereas insurance provides protection from casualty loss and property damage, surety bonds provide protection to assure project completion and a guarantee that

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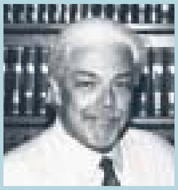
1 The author acknowledges that much of the information for this article comes from the Surety Information Office, The Importance of Surety Bonds in Construction, and Surety Bond Basics, © 1996 by Federal Publications, Incorporated, written by Messrs. Dan Donahue and George Thomas of Fireman's Fund Insurance Company.

columns

Commercial Real Estate Group Contributors



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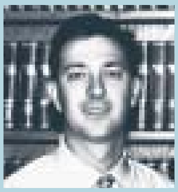

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Damages Other Than Unlawful Detainer Damages

BY SCOTT W. SINGER, ESQ AND PHILLIP H. STOERMER, ESQ.

LANDLORDS ARE GENERALLY FAMILIAR WITH unlawful detainer damages and what types of items are includable in their claim at trial or default. However, even savvy Landlords often times are not aware of the scope of damages which can be sought outside of the unlawful detainer context for breaches of Lease obligations. This article will address all types of monetary damages available to a Landlord other than those available in the unlawful detainer context. For a discussion of unlawful detainer damages, please refer to Berding & Weil's ALERT dated August, 2002.

1. Damages in Excess of One Year Delinquent.

In an unlawful detainer, Rent and Additional Rent (i.e., common area charges, operating expenses, property taxes, insurance, etc.) are only properly included in the action if they are less than one year in arrears. Therefore, following an unlawful detainer, a Landlord may bring an action to collect any Rent or Additional Rent that is more than one year in arrears. Procedurally, a Landlord may opt to file the two actions concurrently, or may pursue either remedy first. The bar to the traditional Rent action is that it must be brought within four (4) years of the date of the default or breach of the Lease (the traditional breach of contract statute of limitations). The action is a traditional breach of contract action for breach of the Lease. One of the practical limitations is the legal cost associated with pursuing a breach of contract action for Rent or Additional Rent more than one year in arrears. However, if a Landlord believes it is dealing with a financially solvent Tenant, and the Lease contains a prevailing attorneys' fees provision, the action may be worth maintaining even over a relatively insignificant sum.

2. Actions for Common Area Charges, Operating Expenses, and Other Charges under the Lease.

In an unlawful detainer action, only "Rent" is collectable. Therefore, most commercial Leases contain a clause which provides that all sums due under the Lease from Tenant to Landlord shall be deemed "Additional Rent." This "Additional Rent" provision is typically found in the default section of the Lease, but may also be found in the Rent, or Operating Expense section of the Lease. The purpose of this clause is to ensure that all other charges due under the Lease are collectable by a Landlord in an unlawful detainer action. In the event the Landlord's form Lease is deficient (or an older Lease), all items not termed "Rent" in the Lease are not collectible in an unlawful detainer. However, all such charges are collectible in a traditional breach of contract action. Therefore, once again, a Landlord could maintain an unlawful detainer action for Rent and possession, and concurrently maintain a breach of contract action for any other unpaid sums under the Lease.

3. Termination of the Lease-Civil Code Section 1951.2.

A *Civil Code* Section 1951.2 action is most commonly initiated by a Landlord after the prosecution of an unlawful detainer. The unlawful detainer theoretically awards the Landlord Rent up to the date of entry of the unlawful detainer judgment (subject to the one year limitation). However, the unlawful detainer action does not award the Landlord future loss of Rents. *Civil Code* Section 1951.2 is a valuable remedy provision entitling the Landlord, under certain specific instances, to recover future Rents under the Lease. *Civil Code* 1951.2 applies only in the situation where the Lease has terminated either by Tenant abandonment, the Landlord terminating the Lease, or otherwise. The remedies available under CC 1951.2 include (i) unpaid Rent at time of termination; (ii) unpaid Rent from time of termination until the time of award; (iii) Rent for the balance of the term of the Lease; and (iv) any other amount necessary to compensate the Landlord for the detriment proximately caused by the Tenant's failure to perform its obligations under the Lease. The availability of damages pursuant to section (iii) and (iv) require that Landlord reasonably attempt to mitigate its damages, which in most cases means relet the Premises. Evidence that the Premises was listed for Lease with a reputable broker generally satisfies Landlord's obligations to attempt to mitigate its damages.

The damages available under CC 1951.2 are the most common measure of damages available to a Landlord because most Leases are terminated in the instance of a significant default. The Lease must be terminated, and therefore, this is a common remedy of landlords following an unlawful detainer, to collect future Rents. Arguably, CC 1951.2 also allows a Landlord to seek to collect unamortized broker's commissions, unamortized Tenant improvement dollars, broker's commission incurred in reletting the Premises, any Tenant improvement allowance provided to the new Tenant, and even the difference in Rent between the amount paid by Tenant and the amount paid by the new Tenant. Factoring in each of these potential damages, especially in a down market, a Landlord's damages figures can quickly escalate. We recommend waiting until the Premises have been released before initiating a CC 1951.2 action so that the Landlord has a clear picture of its damages. While holding off on the action in order to liquidate its damages is always a good idea for a Landlord, the Landlord must also be cognizant of the four (4) year statute of limitations for the claim.

4. Continuing the Lease – Civil Code Section 1951.4.

Civil Code Section 1951.4 is a very valuable remedy to a Landlord, but is available only in limited circumstances. First, the Tenant must have abandoned the Premises. Second, the Landlord must not have taken any action to terminate the Lease. Therefore, the Landlord must not serve a three-day notice, notice of belief of abandonment, or take any other action to terminate the tenancy. Third, the Lease must specifically provide that Landlord is entitled to the remedy provided by CC 1951.4. Fourth, the Lease must permit the Tenant to sublease or assign the Lease, and provide that the Landlord act reasonably in providing or refusing its consent. If each of the foregoing elements are met, then the Landlord may keep the Lease in full force and effect, collect Rent each month as it comes due, with intervention from the court, and the Landlord is not obligated to mitigate its damages. A savvy Landlord with a credit Tenant will: (i) not terminate the Lease; (ii) collect Rent each month as it comes due; and (iii) will not be forced to mitigate damages by seeking to relet the Premises or otherwise. The benefit of CC 1951.4 as opposed to CC 1951.2 is that the Landlord can collect Rent on a monthly basis as it comes due, versus initiating a 1951.2 action which generally requires that a Landlord mitigate its damages, and litigate a traditional action which may take in the range of two years to get to trial.

In practice, 1951.4 actions are relatively rare in today's economic climate. Many tenants who abandon their Premises do not have the financial resources to pay Rent and, therefore, the mechanism of seeking to collect Rent for the term of the Lease is often inapplicable. However, in the somewhat rare instance where CC 1951.4 may be applicable, this remedy provides the Landlord with the ability to collect Rent each month when it comes due by means of a simple application to the court.

Conclusion

Often times the damages available in an unlawful detainer are insufficient to fully compensate a Landlord for the loss it has suffered due to a defaulting or abandoning Tenant. Traditional breach of contract actions can always be brought in order to seek other types of damages such as failure to pay common area costs and operating expenses. A traditional breach of contract action is also available for Rent more than one year in arrears. Landlords are often hesitant to bring such an action unless the dollar amount is significant due to the traditional court time lines and resulting attorneys' fees in comparison to an unlawful detainer. However, with a prevailing attorneys' fees provision, Landlords are more likely to pursue such actions with a credit Tenant. Both CC 1951.2 and CC 1951.4 provide mechanisms to recover Rent for the entire term of the Lease. CC 1951.2 is applicable following the termination of the Lease, while CC 1951.4 requires that the Lease not be terminated. Savvy landlords often use these remedy code sections to their advantage to obtain future rents from credit tenants that either default under the Lease or abandon the Premises. If we can provide Lease remedy consultation for your business, please do not hesitate to call. BW

Alternative Ways of Holding Title to Real Estate

BY ROBERT J. SILVERMAN, ESQ.

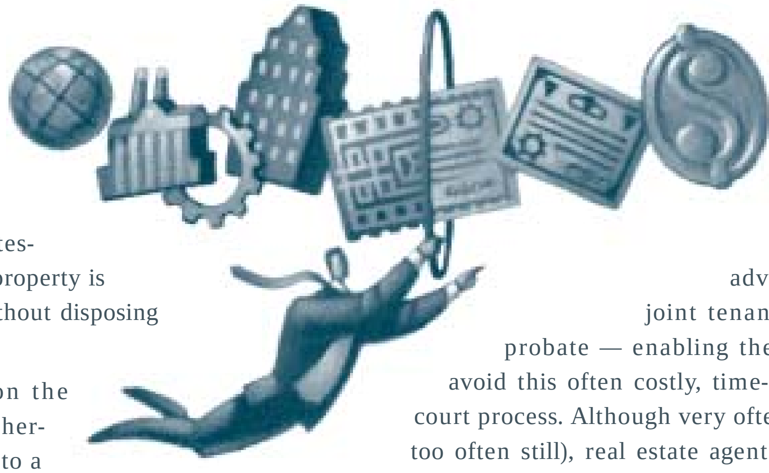
TITLE TO REAL ESTATE CAN BE HELD in many forms. The manner in which a property owner takes title has significant legal and tax consequences! Such consequences may include, among others: whether or not, and to what extent, on the sale or transfer of the property (or a co-owner's interest in the property), income tax is owed on all or a portion of the owner's capital gains; what an owner's rights and obligations are in relation to his co-owners; to whom the property will transfer on an owner's death; whether or not, on acquisition of the property, a parcel is subject to property tax reassessment by the county tax assessor; and to what extent an owner's interest will be subject to co-owner and third party creditor's claims.

An expansion has occurred in the ways in which legal title to property is commonly held. Some previously less conventional forms have become more popular, and a new variation has recently been established by legislation. The primary purpose of this article is to discuss the common ways in which residential property (and to some extent commercial property) title vesting are created, transferred, terminated, and subject to income tax. I'll identify and distinguish the basic features and pros and cons of various ownership forms.

The most common forms are: individually; as "joint tenants"; as "community property"; and as "tenants in common." An increasing number of people are taking title as trustees of their Living Trusts. It is also becoming more common for an individual or small group of investors to form a limited liability company, corporation, general partnership, or limited partnership to acquire and hold title to residential property (in the name of the respective business entity).

Nothing particularly noteworthy is involved when a person holds title to real property individually, except when the individual title holder is married. In the case of married individuals, several presumptions apply. The first is that property acquired during marriage, except property inherited solely by one spouse during marriage, is community property (i.e., each spouse has an interest in the property). The second is that property acquired in the name of one spouse only is separate property. Since these presumptions sometimes conflict, and the law often allows evidence to rebut the applicable presumptions, community property law adds some uncertainty when a married individual is on title alone. As a practical matter, title companies usually require title to be formally held as "John Doe, a married man" or "Jane Doe, a married woman," and sometimes this phrase is tacked on: "as his (or her) sole and separate property." Also, when a married title-holding spouse refinances property, the lender usually requires the non-title holding spouse to sign a Quitclaim Deed, which serves as record of transfer/release of any community property interest in the property to which the non-title holding spouse might have been entitled or claim. It should be emphasized that community property law and related real estate title and ownership issues can be quite complex, and are beyond the scope of this article.

When title is held by a person in his or her individual capacity, upon the sale or transfer of the property, the owner/seller is generally then taxed at the applicable capital gains rate, which (oversimplifying) is the difference between (a) the sales price and (b) the seller's tax basis - the seller's original purchase price plus the cost of improvements made by the seller. Fortunately, a capital gains tax exemption of $250,000 for unmarried individuals is available for eligible sellers who meet the "personal residence" and related requirements of the federal tax code. When the individual title holder dies, the property is subject to probate proceedings. Once probate proceedings are completed, a final pro-



bate order is signed by the judge, thereby transferring the property to whom the decedent owner designated to receive it in his or her Will, or, if no valid Will exists, to the decedent's "intestate" heirs — those to whom property is distributed when one dies without disposing of one's property by Will.

Under current tax law, on the owner's death, the person inheriting the property is entitled to a "stepped up" tax basis. This means that the new owner will have a new tax basis equal to the fair market value on the date of the decedent owner's death. Consequently, if the new owner then sells the property, he or she will only be responsible for paying capital gains tax on appreciation that occurred, if any, after the decedent's death.

Living Trusts

For probate avoidance and other estate planning reasons, unmarried individuals (as well as married couples) are often well advised to hold title as trustee of a Living Trust rather than simply in their individual capacity. When a person(s) holds title to property as trustee of his or her living trust, it is exempt from probate.

Joint Tenancy

When more than one individual (particularly a married couple) purchases a property, joint tenancy is a very popular method of holding title. Joint tenancy features ownership by two or more people, each owning an equal, undivided interest. It is created by using the words "as joint tenants" in a deed in which the co-owners are named as the grantees. It can occur when an existing individual owner grants an interest to himself and one or more others; when several existing "tenants in common" or "joint tenants" grant an interest to themselves and one or more others; or when husband and wife, who hold title as "community property," grant an interest to themselves and/or others.

The "right of survivorship" is the primary characteristic of joint tenancy, and the reason many co-owners have customarily taken title in this form. The right of survivorship means that upon one joint tenant's death, the surviving joint tenant(s) take the entire interest of the decedent by operation of law. The advantage is that the decedent's joint tenancy interest is not subject to probate — enabling the surviving joint tenant(s) to avoid this often costly, time-consuming and inconvenient court process. Although very often in the past (and lamentably too often still), real estate agents, mortgage brokers and title company representatives have routinely suggested that married couples take title to property as joint tenants, it is often unwise. Unfortunately, many co-owners acquire real estate without receiving professional advice from a real estate attorney or accountant. For the reasons described below, the right of survivorship is often not enough of an advantage by itself to make it the optimum manner of holding title.

Tenancy in Common

Holding title as a "tenant in common" with others simply reflects a joint, undivided interest in a property that contains no right of survivorship. Unlike with joint tenants, tenants in common can hold disproportionate shares (unequal fractional interests). It is somewhat unusual for married couples to hold title in this form, but very often friends, other relatives, and those acquiring the property as part of a joint business venture hold title this way. Sometimes one or more tenants-in-common is a passive investor and one or more others live in the property. When taking title as such, it is strongly recommended that all of the tenants-in-common agree in advance upon issues such as: who is responsible for property management; what happens if a co-owner wishes to sell his interest; what happens if a co-owner moves out of the property or wants to lease his interest to a non-owner; what happens if a co-owner dies; what happens if a co-owner wishes to make improvements to the property; which co-owners are entitled to possession. This is best accomplished by a written, attorney-drafted, co-ownership agreement (sometimes also referred to as a "joint ownership," "tenants in common," or "equity sharing" agreement). If the tenants-in-common do not enter into a comprehensive written agreement at the outset, the intentions of the parties are often not well established and clarified, an expensive lawsuit can result, and valuable relationships can be damaged or destroyed.

Community Property

Taking title in community property is an available method for married couples only. When a married couple acquires property, it is presumed to be community property, absent a contrary vesting or statement in the deed. Once again, it is beyond the scope of this article to elaborate on how and when community property interests are created, altered and dissolved, and when one spouse is entitled to reimbursement for property-related contributions of separate property, etc. Suffice it to say that community property title vesting is usually created by using the words following the grantees names: "husband and wife, as community property." Even when the words "as community property" are omitted, the community property presumption should apply. When title is held in another form (e.g., as trustees of a living trust), the parties can affirm by an independent agreement that they wish to have the property treated as community property (regardless of how title is actually vested on the deed).

The big advantage of community property is that the surviving spouse receives a full "step-up" in tax basis upon the death of the first spouse. If a married couple does not hold title as community property, the surviving spouse receives only a step-up in tax basis, creating a potential capital gains tax liability for the surviving spouse that could otherwise have been avoided or minimized.

In the past, the big disadvantage of holding property in community property form was that community property, unlike joint tenancy, does not contain the right of survivorship. Under a new statute that became effective July 1, 2001 (*Civil Code* Section 682.1), married couples who wish to hold title in community property can now choose to include the right of survivorship by so indicating on the deed ("community property with right of survivorship"). By holding title as such, the surviving spouse is able to benefit from the favorable tax status of community property **and**, by means of the right of survivorship, avoid a probate proceeding on the death of the first spouse.

Advantages of Living Trusts Over Joint Tenancies

Joint tenancy has several important disadvantages. First, as long as property is held in joint tenancy, none of the joint tenants can effectively direct the distribution of their property interest by testamentary instrument (Will or Living Trust). The decedent's interest automatically goes to the surviving joint tenant **regardless of contrary instructions that may appear in the decedent's Will or Living Trust.** In the case of unmarried individuals — whether friends, parent-child, grandparent-grandchild, domestic partners, etc. — co-owners too often do not realize that their attempted testamentary disposition of their joint tenancy interest will be ineffective. In the case of married couples, holding title as joint tenants (rather than in community property) accomplishes avoidance of probate — at least on the death of the first spouse — but this is achieved at the expense of losing a valuable tax loophole. In short, if a property was held in joint tenancy, on the death of the first spouse, the surviving spouse is only entitled to a step-up in tax basis as to the decedent's interest, and **not** as to his or her own interest. Many married property owners are unaware that alternatively, if title to a property is held as "community property," the surviving spouse is entitled to a **fully** stepped-up tax basis. This can dramatically reduce or eliminate capital gains tax liability when the surviving spouse sells the property after the death of his or her spouse. Since a capital gains tax exemption of $250,000 is available for a surviving spouse who meets the "personal residence" and related requirements of the federal tax code, sometimes the tax problem is avoided anyway. But, when gain exceeds the $250,000 exemption amount or when the exemption does not apply (e.g., with investment property), having held property as joint tenants rather than community property can be a very expensive mistake.

Holding title in joint tenancy can also be a disaster for the original owner - grantor (often parent or grandparent) - who transfers a joint tenancy interest to a loved one. Often, such grantor later discovers that his or her own interest in what is often his or her most (or only) valuable asset becomes subject to creditors claims or judgments of the grantee - the person to whom the joint tenancy property interest was transferred. Ironically, the grantor in this situation often transfers his or her joint tenancy interest to the grantee as a gift and/or for convenience purposes only (usually to avoid probate).

Another problem with the seemingly innocuous transfer of a joint tenancy interest by one relative or friend to another is that on the death of the original owner/grantor, the surviving joint tenant may not receive a stepped-up tax basis (talk to your accountant about the dynamics of this scenario!). The reason is that when a donee is gifted a property, that donee has a "carry-over" basis; the donee takes over the tax basis of the donor. Thus, on the surviving joint tenant's subsequent sale or transfer of the property, he or she may have a capital gains tax liability that would have been avoided (because of the stepped-up tax basis) if the transfer had not been made by gift, but instead upon the original owner/donor's death (for example, by Will or Living Trust). Finally, many donors make real property gifts without realizing that the gift had gift tax implications. Not only are such gifts frequently unwise from an estate planning perspective, but they often also unknowingly trigger the requirement that a gift tax return be prepared and filed.

Joint tenancies are, of course, terminated when all but one joint tenant dies; the sole surviving joint tenant then owns the property individually. A joint tenancy may be severed by the joint tenants by an express or implied agreement between them (or in other ways, such as by court judgment and foreclosure sale). Importantly, a joint tenancy interest can also be severed **unilaterally** by a joint tenant, and it can even be done without notice to the remaining joint tenant(s). Such severance is typically accomplished by conveyance — the recording of a deed — under which the severing joint tenant grants his interest to himself or to a third party. It may seem odd for one person to convey an interest to himself, but this is a common and appropriate manner in which to retain one's property interest, yet extinguish the joint tenancy. The result is that the grantee in the deed (frequently the joint tenant/grantor himself) thereafter holds title as a "tenant in common" with the other joint tenant(s). Thereafter, the severing joint tenant becomes able, by Will or Living Trust, to direct the disposition of his interest in the property on his death. If there are three or more joint tenants, on severance of the joint tenancy by only one of them, the joint tenancy as between the others is not severed (i.e., the right of survivorship remains intact among the remaining joint tenants).

Advantages of Living Trusts Over Community Property

Although holding title as community property with the right of survivorship is attractive for married couples, holding title as trustees of a Living Trust is most often far more preferable. Among many other estate planning benefits, holding title in this manner enables probate to be avoided not only on the death of the first spouse, but on the death of the surviving spouse as well. The law provides that property held in a Living Trust is not subject to probate, and is disposed of as directed in the trust document, usually without substantial cost or delay, and without court intervention. If the right of survivorship is not chosen, each spouse is free to dispose of his or her interest as they wish by Will or Living Trust.

Holding Title in the name of a Business Entity (e.g., an LLC)

A significant number of investors are choosing to form and hold title to real estate in the name of a business entity. This is particularly so where one or more individuals purchase or own multiple homes, an apartment building, or a commercial property. In California, for a large majority of investors, the limited liability company (LLC) is the entity of choice. It is easy to form and operate, and doesn't require many formalities that a corporation requires. The primary reason for forming and holding title to property in the name of an LLC is that the "members" of an LLC ("LLC members" are analogous to shareholders of a corporation) are entitled to "limited liability" — their liability is generally limited to the amount they have invested. In other words, the individuals' other assets are protected from liability. In view of what seems to be an ever increasing scope and amount of liability associated with owning real estate for investment, many investors err on the side of caution by attempting to shield their home and other personal assets from potential liability arising out of their real estate investments. Of course, limited liability protection is conditioned upon properly forming, capitalizing, and operating the LLC.

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Lease Restructuring– Why, When, What & How

BY BRUCE CARTER

From time to time, Berding & Weil will ask well known members of the commercial real estate community to comment on a topic that we perceive to be of special interest. This first in the series is authored by Bruce Carter, President and CEO of Prudential Commercial Real Estate San Francisco, Inc., a 40-year veteran of the real estate business with extensive experience throughout the western United States who has operated in the brokerage business principally as a Tenant representative for more than 20 years.

Why?

Tenants that have two to four years remaining on a Lease term who have cost reduction, growth, or downsizing needs are all strong prospects for Lease restructure. Although cost reduction by preventing escalating occupancy costs is the primary drive behind most Lease restructuring, every clause in a Lease can have economic significance and every clause is subject to renegotiation during restructuring. But what could entice a Landlord to agree to a mid-lease restructure? When Tenants with space needs are in short supply at the same time that vacancy rates are growing, Landlords become very interested in extending current occupancies. This typically involves trading rental reductions today for Tenant commitments to remain in the Premises for additional periods beyond the current Lease expiration dates.

Another good reason to consider Lease restructuring during a softening market is linked to operating expense and escalation overcharges. In depressed markets Landlords make every effort to attract new Tenants and to recoup lost profits. This often involves increasing services and amenities and/or renovating common areas, and these extra expenses are typically passed through to existing Tenants. Even if a Tenant has previously negotiated operating expense exclusions and has the right to audit operating expenses, complicated invoicing and insufficient documentation can make it difficult to identify miscalculations or deliberate overstatements. Also, the costs of capital improvements are often improperly expensed and passed through to existing Tenants instead of being amortized over a number of years, and Tenants are unknowingly overpaying as a result.

When?

Lease restructuring is most successful when a downward economic cycle is combined with high vacancy rates, which is what we are currently experiencing. Over the past six quarters, with few exceptions, real estate markets across the country have seen increased vacancy, decreased demand, and sluggish activity. And given the typical lag between economic recovery and growth in real estate demand, leasing activity in most markets is not expected to increase significantly until at least late in 2003. Add to this the recent corporate accounting scandals and volatile stock market, and you have the perfect environment for Lease restructuring. Lastly, the current Tenant-favorable market has been sustained for such an extended period of time that Landlords are no longer waiting for the tide to turn.

What?

The great majority of restructuring benefits sought by Tenants involve either lower Rent or flexibility. In recent restructurings that Prudential CRES has been involved with, the primary goal was either immediate Rent reduction, a future Lease cancellation privilege, reduction in the amount of space leased, long-term control over the entire floor of an office building, a Tenant improvements allowance that can also be used to acquire furniture or equipment, or the long-term control of space at below market Rent. A long list of potential economic concessions could include (1) immediate Rent reduction to a Rent rate at or near current "fair market" Rent, (2) a period of "free Rent" that can often be longer and more valuable if spread out during the Lease term instead of taken all at the front end, (3) a "turnkey" refurbishing allowance payable immediately and/or later on during the Lease term, (4) an advantageous adjustment to the Expense Stop or Base Year for operating expense pass-through purposes, (5) Landlord absorption of after-hours HVAC charges or of other direct utility charges such as electricity, (6) Landlord absorption of future asbestos abatement or ADA costs, (7) Landlord absorption of parking charges, (8) more equitable and less expensive indemnification/insurance provisions, and (9) Tenant-favorable default provisions with generous grace periods.

Flexibility concessions can often be just as important as economic concessions. They link to economics indirectly, are generally under the Tenant's control, and can include (1) options to extend the term at below-market Rents, (2) options to expand on terms that match the master Lease, (3) options to cancel the Lease with little or no associated cost, (4) options to downsize without penalty, (5) rights of first refusal and rights of first negotiation in addition to the above options, (6) open transferability of the Lease by sublet or assignment, (7) the addition of non-disturbance and quiet enjoyment provisions, and (8) the addition of a "self help" provision to cover for Landlord non-performance.

Timing and preparation are key to successful restructuring.

How?

Lease restructure is a very complex negotiation involving an in-depth understanding of the Tenant's business model, and analysis of occupancy expenses, in-depth market knowledge, and a skillful negotiator. The ability to find common ground for two parties with conflicting interests is critical, because a successful restructuring must involve "quid-pro-quo" in that both parties must perceive benefits from the transaction.

It's important to have a very clear strategy before attempting Lease restructuring. The process begins with a detailed analysis of the Tenant's specific circumstance. The results of that analysis shape a Lease restructuring strategy that is in line with overall Tenant objectives, and is followed by strong negotiation to ensure Lease terms that are advantageous to the Tenant's bottom line. We recommend that strong consideration be given to involving an experienced third party negotiator, who should be retained before contacting the Landlord and early enough to be involved in establishing strategy and tactics. Properly handled, a Lease restructuring should be easier to negotiate and yet hold more potential for advantage to the Tenant than the original Lease negotiation, because the Landlord has already had good experience with the Tenant. BW

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Lease Restructuring – The Lawyers Perspective

BY PHILLIP H. STOERMER, ESQ.

As Bruce Carter so effectively points out in the preceding article, Lease restructuring occurs most often in a down-cycle in the real estate business. Gone for the moment are the days as recent as two years ago when a Landlord would pay $10,000,000.00 to buy out a Lease of a 75,000 square foot office building with Rent in the $2.00 per square foot range because he could Lease the building at $6.00 per square foot. One look at office vacancy rates in the Bay Area and the projections for return to former occupancy levels makes clear the reason for this change.

On the retail side, many Tenants are struggling. Retail sales are down for the moment and if a Tenant was already struggling, "life support" could be just around the corner. Talk of the possible closing of several hundred K-Mart stores after the first of the year was reported by a generally reliable industry source, though denied, as expected, by K-Mart. With office, industrial and flex space showing large vacancies, Lease restructuring is a fact of most Landlords' lives.

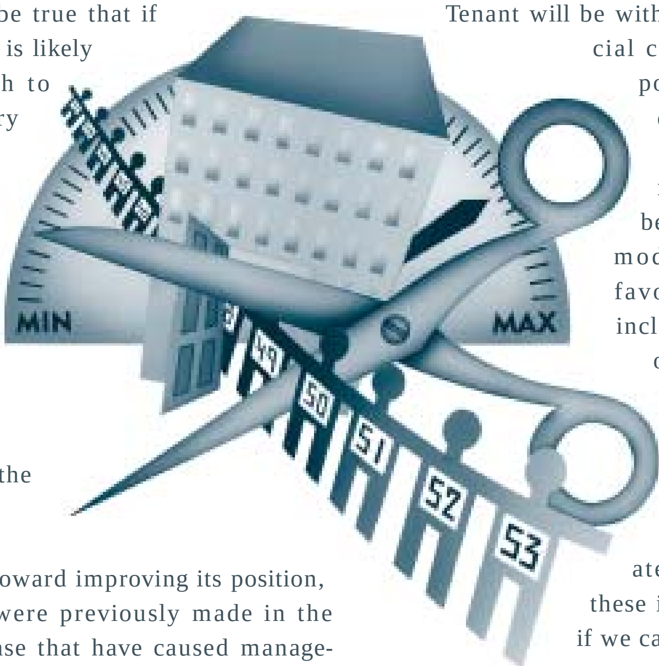
Here are a few scenarios of transactions in which our Firm has been involved.

A major office Tenant caught in the "crunch" sought to reduce their $8.00 per square foot Rent to $2.00 per square foot because the Rent was "too high" and they regard it is "not fair", although they negotiated what was considered a market rate Rent transaction two years ago. They never complained about service or problems in the building, but threatened extensive and costly litigation. The Lease had three years to run with additional options. The Landlord elected to reduce the Rent by 25% in exchange for exercise of the first option together with a waiver of all claims, including potential disputes over operating expenses.

A multi-store retail Tenant in a "turn-around" phase attempting to stem declining sales and reverse the trend was faced with a large number of Leases with above-market Rent. The reason for the excess Rent involved a decision to accept large Tenant Allowances in connection with the build-out of the stores and to amortize a portion or all of the Tenant Allowances as additional Rent. The result was an inability to sublease the Premises or assign the Leases without absorbing substantial losses in each instance. With the assistance of a turn-around specialist, the retailer was able to negotiate a reduction in Rent that eliminated the portion of the Rent related to the Tenant Improvement Allowances. The consideration for the reduction varied in each instance. In some instances, a cash payment was made or promised by the Tenant, in others a letter of credit for a security deposit was provided. In other instances, the consideration to the Landlord involved the early exercise of an extension option or the elimination of an option to extend or expand or purchase the facility. In some cases, exclusive rights to sell certain products were relinquished or prohibitions against changes to site plans were part of the cost to the Tenant and caps on common area expenses or other terms unfavorable to the Landlord were eliminated or compromised, reflecting the need of the Tenant for relief and the willingness of the Landlord to help out based on a long-term and generally satisfactory relationship in lieu of facing even more difficult alternatives. In each instance, amendments to the Lease were ultimately executed. A number of issues arose during the course of negotiations of the amendments, including the modification of the letter of credit language to provide that the letter of credit could be drawn upon only to the extent of the monetary default whereas the Landlord had proposed that any default would entitle it to draw the entire amount with a requirement for a replacement without regard to the size or nature of the default.

While operating covenants are unusual in certain types of real estate Leases, their presence in retail Leases can pose a threat. A court will not generally force a store to stay open but a breach of the covenant can be treated as a default and allow Rent acceleration as a remedy. Therefore, each Lease needs to be examined carefully by the parties to take into consideration the result of simply closing the store. For smaller retail Tenants it may be true that if the store closes, an insolvency is likely and there may not be much to recover. It may be better to try and work something out so that the facility does not sit vacant or look abandoned.

When a Tenant approaches a Landlord for Rent relief, the Landlord must have a clear understanding of the reasons for the request and evidence of financial distress must be verified if claimed by the Tenant. The Landlord should then examine each provision of the Lease with an eye toward improving its position, particularly if compromises were previously made in the negotiation of the original Lease that have caused management problems or unduly restricted the Landlord's ability to Lease the subject property. Everything from the default provision to the assignment and sublease clause should be scrutinized by the Landlord and its counsel as part of the process of deciding to grant the proposed relief.



The interrelation of the Lease and the subordination, nondisturbance, and attornment agreement (the "SNDA") executed between the Tenant and Landlord's lender may also be of concern. Many of the SNDAs proposed by lenders require a provision that no amendment will be effective without the lender's consent. Thus if a lender were to foreclose, the amendment might well not be enforceable against the lender as a successor in interest if their consent to the amendment was not obtained. Our April issue will address the topic of the SNDA.

Of course, all of the potential economic concessions addressed in Bruce Carter's article are on the table when negotiating the Lease restructuring. The variety of resolutions is limited only by the imagination and the relative financial resources of the parties. In a soft market where a Tenant's business is suffering as the result of the general economic malaise, it is not uncommon for the Tenant to seek some relief nor is it to be expected that any such relief granted to the Tenant will be without material cost. Unless the financial condition of the Tenant reflects a potential insolvency with all of the delays and difficulties attendant to formal personal or corporate bankruptcy proceedings, a Landlord may be well advised to offer some accommodation in consideration of other favorable adjustments to the Lease including personal guaranties, waivers of expansion rights or extension options or the granting of operating covenants by the Tenant. Over the 30 plus years of my practice of law, I have seen a number of these cycles and negotiated a wide range of resolutions of these issues. Please do not hesitate to call if we can be of help. BW

Subleasing / continued from cover story- page 1

consent to the proposed Subtenant. The following are typical provisions found in many retail and office Leases which provide the Master Landlord with the right to deny consent to the proposed Sublease: (i) in Landlord's reasonable judgment, the proposed Transferee or the proposed use of the Premises: (a) is other than the Approved Use; or (b) would detract from the status of the Building as a first-class office building; or (c) would generate foot traffic or density materially in excess of the amount generated by Tenant's business; or (d) would impose a materially greater load upon elevator, janitorial, security or other services than is generated by Tenant's business or would otherwise be in excess of that which is customary for the Building; (ii) in Landlord's reasonable judgment, the financial worth of the proposed Transferee does not meet the credit standards applied by Landlord in considering other Occupants under Leases with comparable terms, or Tenant has failed to provide Landlord with reasonable proof of the financial worth of the proposed Transferee; (iii) in Landlord's reasonable judgment, the business history and reputation in the community of the proposed Transferee does not meet the standards applied by Landlord in considering other tenants in the Building; (iv) the proposed Tenant's use of the Building is inconsistent or incompatible with the Building's other Occupants; (v) the proposed Transferee is then an existing or prospective Tenant of the Building; or (vi) Landlord, utilizing all reasonable efforts, is unable to obtain the consent of its Mortgagee to the Transfer, provided that in any event Landlord will be entitled to exercise its right of termination in lieu of consenting to a Transfer.

In today's leasing climate, the Sublandlord may be willing to Sublease to a less than creditworthy Subtenant. However, the Sublandlord must concern itself that the proposed Subtenant will not meet the Master Landlord's criteria in approving or disapproving of a prospective Subtenant. Therefore, while the Sublandlord may be willing to accept almost any prospective Subtenant in hopes of defraying some of its Lease costs, the Sublandlord must be cognizant of the criteria which the Master Landlord will apply in its determination of whether to accept or reject the proposed Subtenant. In the event the Master Landlord denies its consent to a Sublease, the Sublandlord should be aware that in the event a court deems that the Master Landlord's withholding of Sublease consent was "unreasonable," then the Sublandlord is entitled to terminate the Lease. With that termination right in mind, all parties to the proposed Sublease need to carefully strategize decision making in the consent process.

2. Recognition/Attornment.

The subject of recognition is one that is often confused with consent. The Master Landlord's obligation to consent or not consent to a proposed Subtenant is entirely different than a Master Landlord's decision or obligation to recognize a prospective Subtenant. Recognition is the process by which the Landlord "recognizes" the Sublease and the Sublease becomes a direct contractual agreement between the Master Landlord and the Subtenant (subject to the Lease). Subtenants are not normally entitled to be recognized by the Master Landlord unless it is provided for in the Master Lease, or is negotiated as part of the Sublease, or Master Landlord's consent. However, often times a Master Landlord's Lease form will state that in the case of a Sublandlord default, the Master Landlord may choose in its sole discretion whether to recognize the Subtenant or, in the alternative, reject the Sublease. Unless a Tenant or Subtenant forces the issue of recognition at either the Master Lease or Sublease stage, the only mention of recognition will likely be an election by the Landlord whether to recognize the Subtenant in the event of a Sublandlord default. A Subtenant may insist upon a recognition provision in the Sublease document (and consent to by the Master Landlord) as a condition to entering into the Sublease. When recognition becomes an issue for a Sublandlord/Subtenant, the following steps are advised:

1. Review the Lease.

It is somewhat uncommon for a Lease document to provide for the circumstances under which the Master Landlord will recognize a Sublease. However, when representing a Tenant in Lease negotiations, we often advise that such a provision is appropriate in order to protect the "Subleasability" of the space. If such a provision is included in the Lease, it will most likely contain a laundry list of criteria which the Subtenant must satisfy in order for the Master Landlord to recognize the Subtenant. This laundry list is generally very similar to the Master Landlord's laundry list of criteria pursuant to which it can refuse its consent to a Sublease.

2. Negotiate Recognition.

Upon learning of the default of the Sublandlord, discuss the issue of recognition with the Sublandlord, and more importantly, the Master Landlord. If the Lease and Sublease are both void of any obligation on the part of the Master Landlord to recognize the Subtenant, then the Subtenant should openly discuss recognition with the Master Landlord in order to gain an understanding of whether the Subtenant may be asked to vacate the Premises, sign a new Lease, continue in possession under the Sublease, or some alternative arrangement can be worked out. Often times if the Master Lease does not provide a recognition mechanism, recognition can be negotiated as part of the Sublease and consent process.

3. Lease Controls Over Sublease.

In the event of a recognition scenario, it is essential from the Landlord standpoint that the Subtenant is obligated to abide by the terms of both the Sublease and the Master Lease. It is also essential that a provision be added that in the event of a conflict between the Sublease and the Master Lease, the Master Lease will control. The Master Landlord is likely to have much more carefully scrutinized the Master Lease than the Sublease. Furthermore, the Master Lease is most likely the Landlord's form. Therefore, the Master Landlord most likely wants to ensure that the Master Lease is the controlling document even in the event of a recognition of the Sublease.

In the event a Tenant is presented with a Landlord's form Lease which does not address recognition, from the Tenant's perspective we generally recommend the following language:

> "To the extent that Tenant enters into an assignment of the Lease or enters into a Sublease for all or any portion of the Premises, Landlord, if it grants its consent to such Assignment or Sublease, which consent shall not be unreasonably withheld, conditioned, or delayed, will also simultaneously execute and deliver a recognition agreement pursuant to which Landlord will agree that in the event Tenant defaults under the Lease and the Lease is terminated, the assignment or the Sublease will be recognized as a direct Lease between Landlord and the assignee or subtenant on the terms and conditions of the Assignment or Sublease to the extent same are not inconsistent with, or contrary to, the provisions of this Lease and at a Rent rate that is the greater of the Rent rate under the Lease or the Rent rate under the Assignment or Sublease."

This recognition language provides that in granting its consent to a Sublease, the Master Landlord also agrees to recognize the Subtenant in the case of the Sublandlord's default. This language is very aggressive from the Tenant's counsel, and most likely would be rejected in whole by Landlord's counsel.

In the event that a Tenant requests a recognition provision in the Master Lease in order to protect the Subleasability of the Premises, we recommend the following very carefully tailored language:

"a. Sublease Recognition. If Landlord elects to terminate this Lease due to the occurrence of an Event of Default, or if Tenant rejects this Lease in the course of a bankruptcy proceeding, Landlord agrees to recognize any Sublease that Tenant entered into during the Term pursuant to the requirements set forth in the Clause (insert # of assignment/subletting clause) of this Lease (the "Authorized Sublease") as a contract between Landlord and the Subtenant. Such recognition will be effective as of the date of the termination or rejection of this Lease, as applicable (the "Recognition Date"), and Landlord will not disturb the Subtenant's possession and occupancy of the Subleased Premises during the term of the Authorized Sublease; provided that: (i) the Subtenant, on the Recognition Date, meets or exceeds the standards set forth in Clause (insert # of assignment/subletting clause) of this Lease; (ii) on the Recognition Date, the Subtenant is neither: (a) in default under the Authorized Sublease; nor (b) an affiliate of Tenant; (iii) the Rent per square foot to be paid by the Subtenant under the Authorized Sublease (the "Recognition Rent") equals or exceeds the higher of: (a) the Rent per square foot then due under this Lease; (b) the Rent per square foot then due under the Authorized

Sublease; or (c) the prevailing market Rent for comparable space in the (Building/ Center): (iv) if the square footage of the Subleased Premises equals less than 100% of the square footage of the Premises, Landlord determines, in its sole discretion, that: (a) the Subleased Premises are of a size and configuration that is leasable; and (b) the remaining space within the Premises is of a size and configuration that is leasable; (v) the Subtenant agrees in the Authorized Sublease that as of the Recognition Date it will: (a) attorn to and accept Landlord as its direct Landlord under the Authorized Sublease for the remainder of the term under the Authorized Sublease; (b) comply with the applicable terms and conditions of this Lease and perform all obligations of Tenant under this Lease with respect to the Sublease Premises; and comply with all the terms and conditions of the Authorized Sublease, and perform all of its obligations thereunder; (c) pay directly to Landlord the Recognition Rent and all other amounts payable under the Authorized Sublease, when due thereunder; (d) pay directly to Landlord Tenant's proportionate share of Additional Rent, escalations, and all other amounts required to be paid by Tenant under this Lease with respect to the Sublease, when due hereunder; (e) deliver to Landlord a security deposit equal to (insert #, e.g., 2) months' Recognition Rent; and (f) neither exercise, nor cause Tenant to exercise on the Subtenant's behalf, the rights of Tenant that are set forth in Clauses (insert #s of clauses that grant special rights or options to Tenant) of this Lease; (vi) the Subtenant agrees in the Authorized Sublease that Landlord, its successors, and assigns will not be: (a) subject to any credits, offsets, defenses, or claims that the Subtenant might have against Tenant; (b) liable for any act or omission of Tenant; (c) bound by any covenant to undertake, complete, or pay for any improvement to the Subleased Premises; or (d) required to account for any security deposit other than the security deposit actually received by Landlord or its successors and assigns; (vii) as of the Recognition Date, the Subtenant agrees in the Authorized Sublease that Landlord may communicate directly with and proceed directly against the Subtenant, with or without notice to or the involvement of Tenant to enforce all of the obligations of Tenant under this Lease or the obligations of Subtenant under the Authorized Sublease with respect to the Subleased Premises; (viii) the Subtenant agrees in the Authorized Sublease that Landlord is not bound by any provision in the Authorized Sublease that: (a) creates any rights or remedies in the Subtenant that are greater than the rights of Tenant under this Lease; or (b) increases Landlord's obligations under this Lease; (ix) if this Lease terminates due to the occurrence of an Event of Default, Tenant remains primarily liable for the performance of all of its agreements, covenants, obligations under this Lease (including, without limitation, the obligation to pay the full amount of all Minimum Rent, Additional Rent, and other sums, charges, and reimbursements set forth in this Lease), and any payment obligations that arise in connection with any act or omission of any Subtenant; (x) if Landlord, in its sole discretion, agrees to amend, transfer, renew, extend, or modify the Authorized Sublease, or to sign a Lease with the Subtenant directly, Tenant remains primarily liable for all payment and performance obligations of Tenant under this Lease; and (xi) Landlord's lender, if any, has approved the Authorized Sublease, if such approval is necessary.

b. Personal Right. This right of recognition of an Authorized Sublease is personal to the initial Tenant under this Lease and is not transferable to any Assignee or Subtenant of the Initial Tenant.

c. Indemnification. Tenant hereby indemnifies Landlord from and against any brokerage commissions, finders' fees, or any other charges that may arise in connection with the Authorized Sublease.

d. Survival. This Clause will survive the expiration or earlier termination or rejection of this Lease."

3. Release of Liability.

As a general rule, a Sublease or assignment does not release the Sublandlord of liability under the Master Lease. Instead, the Sublandlord remains primarily liable for the obligations of the Lease. The Subtenant is liable to the Landlord only to the extent of a recognition/attornment situation. Otherwise, while the Subtenant is not contractually bound to the Master

Landlord, nevertheless, the Master Landlord should name the Subtenant in any unlawful detainer (as well as any other person with a claim to a right of possession) in order to ensure that the Master Landlord is able to regain possession of the Premises. The Master Landlord's most valuable remedy is against the Sublandlord due to the contractual relationship that exists between the Sublandlord and the Master Landlord. If the Sublandlord proposes a highly creditworthy Subtenant, the Sublandlord should consider negotiating with the Master Landlord for a release of liability. The Master Landlord is not obligated to give this release, but with the introduction of the right Subtenant, a reasonable Master Landlord may consider such a request.

4. Require Subtenant to Abide by Terms of the Lease.

Because the Sublandlord remains primarily liable under the Master Lease, the Sublandlord should insist in the Sublease document that the Subtenant agree to strictly abide by the terms of the Master Lease. If this provision is not included, the Subtenant is not required to follow the terms of the Master Lease, and the Sublandlord will be liable for those defaults or breaches caused by the Subtenant's failure to abide by the terms of the Master Lease. BW

Alternative/ continued from page 7

Some investors choose not to incur the fees and costs, and extra administrative obligations associated with formation and maintenance of an LLC or other business entity. Instead, these investors rely upon the asset protection that comes from a more traditional risk management approach — maintaining comprehensive general liability insurance policies and optional coverage/endorsements applicable to landlords. In many instances, maintaining elaborate insurance coverage with large policy limits is a sufficient asset protection measure; however, it can be difficult for real estate investors to predict or anticipate all of their many types of liability risks associated with uninsured claims, claims in which exclusions apply, or claims in which damages awarded exceed policy limits. Such potential gaps in insurance coverage may seem, or may in fact be, somewhat remote. Nevertheless, the relatively minor cost and inconvenience associated with forming and owning property in the name of an LLC or corporation is perceived by many investors and professionals as well worth the limited liability achieved thereby.

Although corporations also offer their shareholders limited liability, corporations are generally (except for S Corp.'s, which have other requirements and limitations) subject to double taxation — the corporation is taxed on revenues it generates, and shareholders are taxed on dividends paid by the corporation. An LLC can (and almost always does) elect to be taxed as a partnership rather than a corporation. As such, the LLC is not taxed at the entity level, and profits & losses "pass-through" to the individual members (so that double taxation is avoided). Estate and gift tax benefits can also accrue to investors who hold fractional interests in property with others in an LLC. These and certain other income and property tax ramifications (that are beyond the scope of this article) apply, and should be explored carefully with professional tax and legal advisors before deciding on establishing a business entity for real estate ownership. BW

Surety Bonds/ continued from cover story- page 1

laborers, suppliers and subcontractors to the project will be paid, thereby relieving owners from the risk of financial loss arising from liens filed when these same parties are left unpaid by the contractor. This "protection of the property" provides a smooth transition from construction to permanent financing by eliminating liens on private projects. And, because surety companies will typically only bond contractors who are experienced, who are creditworthy, who have the ability to obtain the necessary equipment and personnel to do the work, and who have sufficient financial strength to collateralize the bond, a contractor that qualifies for a bond (irrespective of whether it is required or not) is an important gauge for the owner to look to in order to assure itself that a qualified contractor is working on the project.

Since the first of the year, surety bonds have taken on a new and important role to property owners and asset managers. California passed new legislation[2] this year that turns the table on identifying the creditworthiness of the contractor and requires owners to show their creditworthiness to contractors. This new legislation requires owners of real property who contract for a work of improvement where the contract exceeds $5 million, and certain holders of lesser property interests, such as tenants or subtenants, who contract for a work of improvement where the contract exceeds $1 million, to provide financial security **to** the contractor, i.e., to post a bond or other security that they will guarantee payment to the contractor in the event of owner failure. This *reversal of creditworthiness* roles will provide even more reason for owners and asset managers to understand surety bonds and it will open the door for property owners and asset managers to become more creative in using surety bonds to protect their interests and, now, to meet their statutory financial security obligations.

Surety Bond Fundamentals

Let's explore the fundamentals of a surety bond. A good starting place is to describe what it is not. A surety bond is **not** an insurance policy. And it is **not** generally issued by a commercial liability insurer. It is also **not** a letter of credit. And it is **not** normally issued by a bank. Rather, surety bonds are *guarantee* agreements. Surety bonds are usually issued by corporate sureties. The surety bond "guarantee" is made by the corporate or other surety to an "obligee" that the "principal" identified in the bond will perform an "obligation" stated in the bond.

In the typical construction or tenant improvement situation, the corporate surety will guarantee to the project owner that the contractor will perform the scope of work set forth in a construction contract. Surety bonds normally provide that if the principal (in this instance, the contractor) fully performs the obligation, then the bond is void; otherwise, the bond remains in full force and effect and subject to the project owner's claim that the contractor has defaulted on their bonded obligation[3]. If the principal fails to perform the obligation stated in the bond, both the principal and the surety are liable on the bond to the obligee (in this case, the project owner) and the contractor and surety are "jointly and severally" liable to fulfill the obligation owed to the project owner under the bond (i.e., the project owner can sue either one or both of them and the entire liability can be collected from one or the other). Since the corporate surety is a financially sound captive to the obligation, the project owner is protected from a financial disaster brought on by the contractor's failure to perform. Without a surety bond, the project owner would have to financially rescue itself with its own funds at the expense of further job completion and jeopardy to its balance sheet and financial statements.

Thus, surety bonds provide financial security and construction assurance by assuring project owners that contractors will perform the work they contracted to perform and will pay their laborers, subcontractors, and material suppliers for the work they perform. In essence, the surety bond works as a *risk transfer* mechanism where the surety company guarantees to the project owner that the contractor will perform the work of the contract and its payment obligations to those who perform the work and supply the materials. With a surety bond, the risks of failure of project completion and payment from the contractor to its subcontractors and suppliers are shifted or *transferred* from the owner to the surety company.

Since the late 1890's, the U.S. Government has required con-

2 California Civil Code Section 3110.5 (effective January 1, 2002) requires owners of fee simple interests who contract for a work of improvement where the value of the work exceeds $5 million, and owners of less than fee simple interest who contract for a work of improvement where the value exceeds $1 million, to provide financial security to the contractor.

3 Surety bonds also typically include a private statute of limitations that terminates the guarantee of the surety if no claim is filed in court on the bond within the time period set forth.

tractors on federal public works of improvement to obtain surety bonds to guarantee their performance of the work and their payments to subcontractors and material suppliers.[4] This requirement has been a means of protecting the government and taxpayer dollars from contractor failure. Similarly, project owners for private works of improvement can take advantage of the same protection for the benefit of their projects, shareholders, investors, lenders, and principals.

The Types of Surety Bonds

There are different types of surety bonds. The three most common are bid bonds, performance bonds, and payment bonds. Only the latter two will be discussed here.

In the earlier paragraphs we described surety bonds that guarantee to the project owner that the contractor will *perform* its scope of work and will make *payment* to its subcontractors. In the new legislation affecting project owners of significant works of improvement, we described how the statute requires the contracting owner to provide security for the contracting owner's payment obligations to the contractor under the construction contract. The surety bonds that satisfy these requirements are called *performance* bonds and *payment* bonds.

A *performance bond* protects the project owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions, including meeting the price of the contract and keeping the schedule of time for performance. If the contractor defaults in performance, the project owner may call upon the surety to perform and complete the contract. In this case, surety bonds typically provide the surety with three options: (1) completing the contract itself through its own contractor, (2) selecting and paying for a new contractor to contract directly with the owner, or (3) allowing the owner to complete the work with the surety paying the costs. In any of these three scenarios, the surety is liable for the completion work up to the "penal sum" of the bond, which is usually the prime contract sum plus any change orders.

A payment bond guarantees that the contractor will pay certain subcontractors, laborers, and material suppliers on the project. Additionally, to satisfy its new security obligations under *Civil Code* section 3110.5, an owner can secure a payment bond for the benefit of all claimants: contractors, subcontractors, laborers, material suppliers, and equipment renters alike.

In the first instance, the owner receives protection from the contractor's failure and the subcontractors, laborers and material suppliers are the "beneficiaries" of the payment bond. The owner benefits indirectly from a payment bond in that the bond assures such subcontractors, laborers, and material suppliers that they will get paid on the job if they continue their performance. If the contractor fails to pay them the money that the owner has paid the contractor, they may collect from the contractor or the surety up to the penal sum of the payment bond. The penal sum on a payment bond is usually less than the total amount of the prime contract since it is meant to cover just anticipated costs to the subcontractors, laborers, and suppliers.

In the latter instance, under *Civil Code* section 3110.5, the contractor receives protection from the owner's failure and the subcontractors, laborers and material suppliers are once again the "beneficiaries" of the payment bond. The contractor benefits, too, because the payment bond assures the contractor that it will get paid for the work that it has performed, and that its subcontractors, laborers, and material suppliers will be paid.

Contractor Failure is Risky and Expensive Business

Contractor failure can be disastrous to the project owner's bottom line. Contractor failure can take many different forms abandonment of the work, embezzlement, untimely performance, failure to complete the work, and failure to pay subcontractors and material suppliers for their work and materials. The Surety Information Office (SIO) maintains that "[c]onstruction is a very risky business." Citing a Dun & Bradstreet report entitled *Business Failure Record*, the SIO reports that an average of 10,000 contractors fail each year![5] In their wake is a trail of unfinished construction projects and unpaid workers, subcontractors, and material suppliers. With every contractor failure there is the risk of abandoned and delayed projects, increased financing costs, capital calls, lender inquiries, lost tenants, litigation and litigation costs, clouded property titles and foreclosures. Surety bonds can take away the risk of these problems. The bonds offer assurance that a contractor is capable of completing the contract

4 The Miller Act (40 U.S.C. Section 270a et seq.) requires contractors to obtain performance

5 Interestingly, the SIO reports that contrary to what might otherwise be expected the age of a business is not a good indicator of ability to perform. The following percentages are attributable to construction failures by age of business: 5 years or less (32%); 6 - 10 years (29%); and over 10 years (39%).

on time, within budget, and according to specifications. Because surety bonds can be obtained from reputable, secure financial institutions that are qualified and licensed to transact suretyship within the state of California, surety bonds provide dependable, proven, and reliable protection against contractor failure.

Whereas the use of contractor surety bonds on public work projects is typically mandatory, the use of contractor surety bonds on privately-owned construction projects is at the owner's discretion. With the recent passage of *Civil Code* section 3110.5, project owners involved in securing significant dollar value improvements for their property are required to post proof of financial wherewithal either in the form of a line of credit, assets, or a surety bond. To distinguish them from the contractor surety bond they can be called owner surety bonds. It is important to understand that there is a difference between contractor surety bonds and owner surety bonds as they accomplish different protections by establishing different legal relationships. Once understood, project owners and asset managers can become more creative on securing bonds and structuring projects to satisfy their own financial obligations and also receive protection against the contractor's failure. And, while surety bonds do add a cost to completing a project, these costs are relatively minor when weighed either against an owner failure to meet its statutory bonding obligation or against a contractor failure and expenses associated with lost time, lost rent, and litigation.

Securing a Surety Bond

The typical cost of a performance bond is a one-time premium of 0.5% to 2% of the construction contract amount. This can vary depending on the size of the project and the contractor's bonding capacity. The better the contractor's bonding capacity (and the more dependable the contractor) the less the premium charged. Payment bonds will typically be issued at no extra charge when issued in conjunction with a performance bond. Otherwise, again the bonding capacity, the dependability, and the credit history of the contractor will dictate the amount of the premium.

Whether the owner is securing a bond for itself to meet its obligations or is requiring a contractor to secure a bond, the owner will want to make sure that the surety is capable of responding to the failure. The best means for identifying a responsible surety is to look at the list of corporate sureties approved by the Department of the Treasury to issue bonds for federal projects. The Department identifies approved corporate sureties in **Treasury Department Circular** 570. In approving corporate sureties, the Department of the Treasury makes a determination of the financial strength of the surety, and it also sets a "bonding limit" or underwriting limit for the surety. Accordingly, a good place for the private project owner to shop for a surety is at **Treasury Department Circular** 570.[6]

Conclusion and Considerations

In conclusion, surety bonds "bond" the contract and assure project completion; help assure a qualified contractor on the job; guarantee that laborers, suppliers, and subcontractors will be paid; relieve the project owner from the risk of financial loss arising from mechanic's liens filed by unpaid laborers, suppliers, and subcontractors; provide an intermediary to whom the owner can complain; and otherwise screen out unqualified contractors and irresponsible bids. Performance bonds plainly protect the owner from contractor default and delays, which helps commercial property owners keep fixed tenant availability dates. Payment bonds protect against mechanic's liens filed against the property, which otherwise will interfere with sale or refinancing of the property. Property owners and asset managers need to be careful that their contract language matches their bonding expectations and obligations. Also, project owners need to be aware of the new statutory requirements of providing security for their payment to contractors. While AIA form contracts contain language regarding bonds, they don't address securing bonds before the construction starts and they don't address how the bond language and responsibilities will or can be coordinated with the construction contract language. Finally, the AIA forms do not address the project owner's statutory duty to provide security for the contractor under *Civil Code* section 3110.5. As discussed here, a surety bond may be just the answer for protecting the property and satisfying the requirement. BW

6 Copies of the circular can be obtained directly from the Treasury Department and the circular is posted on the Treasury's Web site at www.fms.treas.gov/c570. The circular lists the name and address of each approved surety and all states where each surety is licensed.

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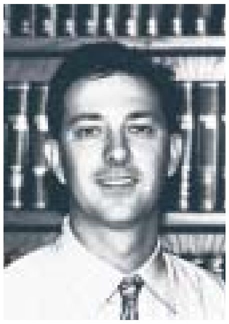

FOR THE PAST SEVERAL YEARS, Scott Singer has served the needs of commercial real estate clients. A California native, Scott attended U.C. Riverside where he majored in Economics, and attended law school at Southwestern University School of Law in Los Angeles. Scott has lived in various locations throughout the Bay Area since 1997. Recently married, Scott now resides in San Ramon with his wife Tara. The primary focus of Scott's practice is commercial real estate, with an emphasis on commercial leasing, commercial lease disputes, unlawful detainers, purchase and sale transactions, lender representation, and all aspects of the operation, maintenance, leasing and sales of office buildings and shopping centers. Scott is a contributing author to several legal publications for real estate practitioners, including the California Continuing Education of the Bar Office Leasing series, as well as the Miller & Starr five volume forms series. Scott is a frequent lecturer on the subject of commercial leasing and commercial lease remedies and defaults. Scott is a member of the International Council of Shopping Centers (ICSC), Building Owners and Managers Association (BOMA), and the Institute of Real Estate Management (IREM). In his personal time, Scott enjoys a good game of golf, reading, travel, and spending time with Tara. BW

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