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COMMERCIAL REAL ESTATE
ALERT

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ADDRESSING THE NEEDS OF COMMERCIAL REAL ESTATE PROFESSIONALS

The New California Civil Code §3110.5

New Requirements That an Owner in a Construction Project Post Certain Forms of Security to Ensure Payment on the Construction Contract

BY SCOTT W. SINGER, ESQ.

CALIFORNIA CIVIL CODE §3110.5 BECAME effective on January 1, 2002, with an implied purpose of providing contractors with security to protect against an owner's non-payment pursuant to a construction contract. Traditionally, contractors have been protected from non-payment in a variety of statutory schemes as well as modern practices invented and perfected by contractors to secure their claim. Mechanic's liens, stop notices, and bond requirements are considered by many in the construction industry sufficient to protect a contractor's payment rights. After all, foreclosure of the project by means of foreclosure of a mechanic's lien action should under normal circumstances be sufficient to satisfy the debt owed to almost any contractor. The process is somewhat burdensome, technical, and expensive. However, the protections of mechanic's lien law generally protects a contractor from non-payment. Furthermore, over time contractors have created clever construction contract language to further ensure payment of the contract amounts. Concepts such as work stoppage rights, timely payment clauses, and clauses which require payment through

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Brief Overview of the Development of Vineyards in Napa Valley, California

BY ROBERT L. YOUNG, ESQ.

THE APPROACH TO THE WINE industry by businessmen, lawyers and other investors often begins with falling in love with the concept of being in such business. However, very early they discover that developing, owning and operating vineyards and wineries in Napa Valley is much like any other business... a lot of hard work. The usual start-up steps required to develop California real estate and operate a business on it are generally the same as the development of vineyards in

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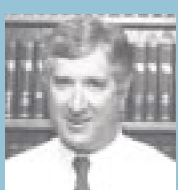

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When Will a Landlord's Notice of Non-Responsibility for Tenant Improvements Fail?

The $2.4 Million Question.

BY CLIFFORD R. HORNER, ESQ AND DANIEL L. ROTTINGHAUS, ESQ.
SPECIAL CONTRIBUTOR: ARNIE HOLLANDER, VICE PRESIDENT AND PROJECT DIRECTOR THE LURIE COMPANY

Howard S. Wright Construction Co. v. Superior Court (BBIC Investors, LLC) 106 Cal. App. 4th 314 (February 14, 2003).

Case Summary — Landlord's Notice of Non-responsibility held ineffective to protect the Landlord from the $2.4 million mechanic's lien claim brought by a Tenant's TI contractor against Landlord.

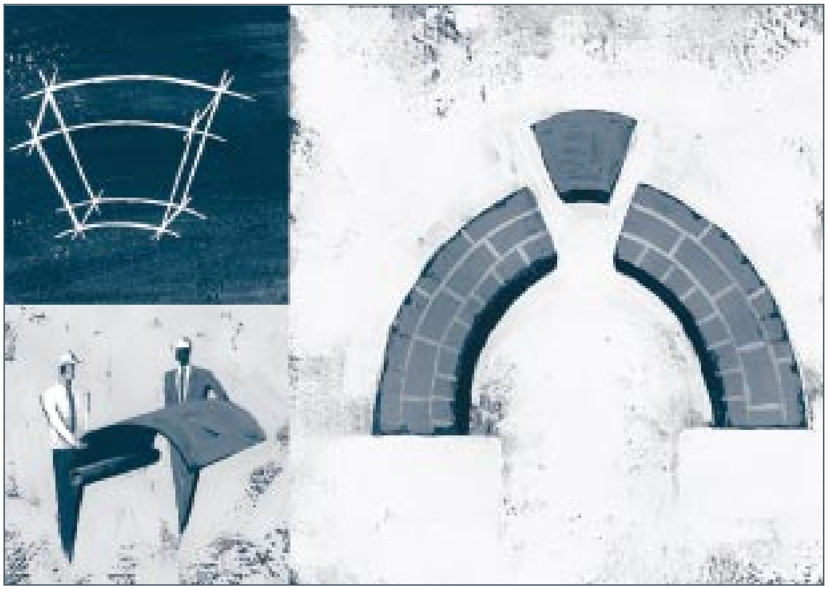
COMMERCIAL LANDLORDS OFTEN expressly agree in the Lease to allow their Tenants to construct substantial improvements to their leased property. Landlords then commonly post and record a Notice of Non-responsibility to shield themselves from liability from the Tenant's contractor if the Tenant fails to pay for the improvements. However, are these notices adequate to shield a Landlord from the contractor's mechanic's lien and foreclosure action if the Tenant fails to pay? Probably not, according to a recent Court of Appeal decision in the First District of California (which includes all Bay Area counties).

It has been a longstanding rule under California's "participating owner doctrine" that mechanics, materialmen, contractors and the like have an automatic lien on property upon which they have bestowed labor or furnished material as long as the work was done "at the instance of the owner" or the owner's agent. (See Cal. Const., Art. XIV, § 3; *Civil Code* § 3110.) When a Tenant orders work to be performed on leased premises with the owner's knowledge, the work is deemed to be "at the instance of the owner" *unless* the owner serves a Notice of Non-responsibility under *Civil Code* § 3129. However, *a Notice of Non-responsibility is of no effect when the Landlord "caused the work of improvement to be performed."* (*Civil Code* § 3094.) This is the "participating owner" doctrine, which provides a key exception to the effectiveness of a Landlord's serving and recording of a Notice of Non-Responsibility.

The "participating owner" doctrine has a long history. A majority of states have adopted the general rule that the installation of leasehold improvements by a Tenant cannot subject the Landlord's ownership interest to mechanic's lien liability if the Landlord provides notice of his non-responsibility. In California, however, the Courts have created the "participating owner" exception to this rule whereby the Landlord's notice is deemed ineffective if the owner is a "participant" in the work of improvement. The owner is found to be a participant and a "participating owner" generally in the following scenarios:

- When the terms of the Lease impose a *mandatory duty* upon the Tenant to make improvements to existing structures the owner is deemed to have "*caused the work to be performed.*" (See *e.g.*, *Baker v. Hubbard* (1980) 101 Cal. App. 3d 226; *Ott Hardware Co. v. Yost* (1945) 69 Cal. App. 2d 593.)
- When the owner plays an *active role* in the installation of the improvements (*e.g.*, when the owner retains control and/or approval over the plans, specifications, mode, timing, and method of the construction of the improvements). (See *Ott*, *supra*.)
- When the owner has an *ongoing interest* in the continuing operation of the Tenant's business, *i.e.*, through a percentage rental agreement. (See *Los Banos Gravel Co. v. Freeman* (1976) 58 Cal. App. 3d 785.)

What seems to be rapidly changing and expanding are the circumstances which give rise to an owner being deemed to have "caused the work to be performed." As set forth in the first bullet point above, it has been the rule in California for years that the Tenant may be treated as an agent of the Landlord (so that the Landlord is deemed to have "caused the work to be performed" under the participating owner doctrine) when the Tenant is *required* by the Lease to make the improvements. (*Ott Hardware Co. v. Yost* (1945) 69 Cal. App. 2d 593, 597–599.) On the other hand, when the improvements are *optional* with the Tenant, the Notice of Non-responsibility has historically been effective to relieve the Landlord from mechanic's lien liability (and the lien would then attach only to the Tenant's improvements and its leasehold interest). (*English v. Olympic Auditorium, Inc.* (1933) 217 Cal. 631, 642–643.)



In *Howard S. Wright Construction Co. v. Superior Court* (BBIC Investors, LLC) 106 Cal. App. 4th 314 (February 14, 2003), however, the Court expanded this doctrine to the extreme detriment of Landlords. In *Howard S. Wright*, prior to the Lease between the Landlord, BBIC, and its Tenant, 360networks, a startup telecommunications company, the premises consisted of a warehouse. The "initial alterations" identified in the Lease included bringing telecom cabling to the building, increasing the electrical supply, and adding more air-conditioning and a back-up generator. The Lease required 360networks to obtain BBIC's approval of the plans and specifications for the work. BBIC also met regularly with the contractor, insisted on certain (minor) modifications to the work, and BBIC collected a $5,000 per month administrative fee for "overseeing the construction." Several months into the work of improvement, 360networks filed for bankruptcy. The contractor pursued BBIC for payment for this work. Because of BBIC's Lease terms and oversight of the improvement work, the Court found the Landlord's properly recorded and served Notice of Non-Responsibility ineffective against the insolvent Tenant's contractor's $2.4 million claim for the recovery of payment for its Tenant Improvement work.

As noted by the Court, commercial Landlords who become involved in controlling the timing and scope of construction work by their Tenants act at their peril with respect to the "participating owner" doctrine. The Court was unconcerned that the improvements were never completed, leaving BBIC with a partially-renovated space, and that BBIC then incurred the added expense of demolishing some of the work and completing other parts to make the space tenantable. As stated by the Court, "Those post-hoc events . . . are irrelevant to an analysis of the participating owner doctrine. Our focus must be confined to the parties' intentions at the time the improvements were undertaken."

What is most alarming about the *Howard S. Wright* decision for Commercial Landlords is that the *Howard S. Wright* Court *also found the fact that the Lease did not require the improvements unpersuasive*. The Court held that the determinative question was whether "the improvements were a practical necessity for the contemplated use of the premises." With this holding, the *Howard S. Wright* Court arguably expanded the "participating owner doctrine" *ad infinitum*. The Court arguably exposed *every* Landlord in the state of California to mechanic's lien liability to its Tenant's contractor, *regardless* of whether the Landlord served and recorded a Notice of Non-responsibility, regardless of whether or not the work was required in the Lease, and regardless of whether the owner controlled the timing and scope of the work, because in practical terms *every* Tenant's Improvement is a "practical necessity" for the conduct of its business. It is difficult if not impossible to imagine any Tenant other than a simple warehouseman that can do business in a vanilla shell. The Court could have found in favor of the contractor in the *Wright* case without infinitely

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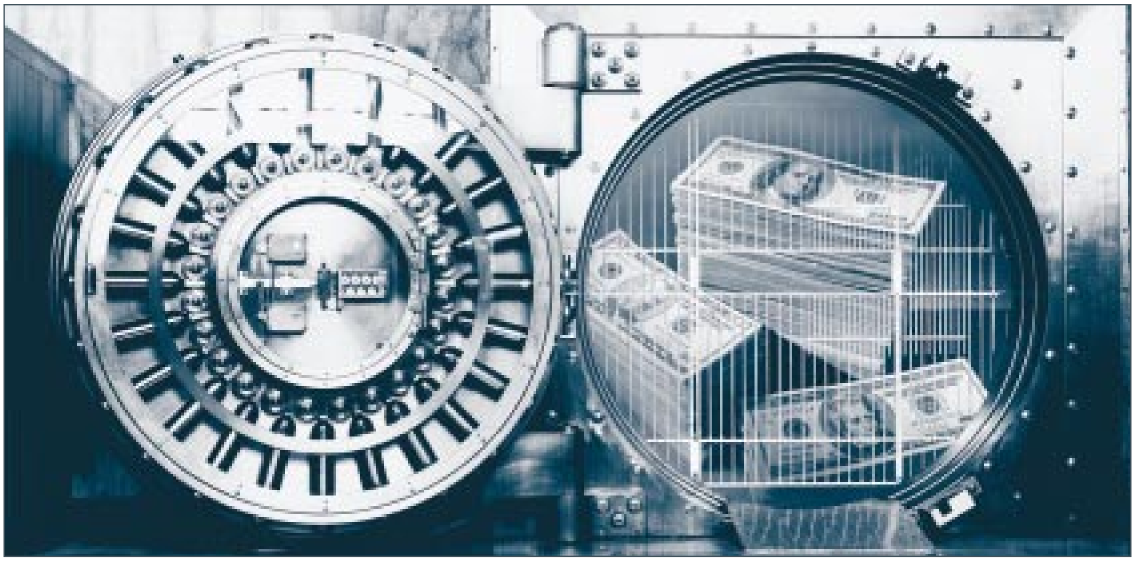
The Elements of Subordination, Non-Disturbance and Attornment

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



LEASE PROVISIONS REGARDING SUBORDINATION, non-disturbance and attornment are increasingly the subject of controversy between Landlords and Tenants. This is perhaps most relevant in the context of retail properties although many of the considerations in this article apply across the spectrum of real property Leases. High vacancy rates lead to foreclosures. Foreclosures lead to automatic Lease terminations in the absence of provisions protecting the interests of the Tenant and the lender against such harsh results. While this may actually be a benefit to a Tenant bound by an above market rent Lease, it is not likely to be in either the lender's interest to have a terminated Lease in a property that it will own that already has problems (*i.e.*, why else foreclose), nor is it usually in the Tenant's interest to find itself without a Lease, particularly when large sums of money have been spent for Tenant Improvements. Therefore, a careful review and understanding of the provisions of a Lease pertaining to the elements of subordination, non-disturbance and attornment is necessary.

An agreement not to disturb the possession of a Tenant (a Non-Disturbance Agreement or "NDA") can and should be an important consideration for Tenants in Lease discussions. If a Tenant plans to expend major funds to improve the Landlord's property, it should seek the protection of an NDA against loss of its Lease in the event Landlord's lender forecloses on the property. If the property is owned by the Landlord without debt (as in the case of some major institutions), a representation by Landlord to that effect should be included in the Lease together with carefully crafted provisions relating to non-disturbance in the event of future debt encumbrances. The size of the Tenant is often a determining factor of whether such protection will be provided. Small Tenants, however, should seek the same protection. Major Landlords are often reluctant to ask lenders for an NDA so that some Tenants simply are forced to take the risk. Chain Tenants and other large users, however, will insist on some form of non-disturbance protection and will be able to obtain it. The opportunity to remedy the situation may occur at a later date on a refinancing or sale when it will be possible to condition the Tenant's agreement to subordinate its leasehold estate upon an agreement not to disturb the Tenant's possession in the event of a foreclosure. A further rationale that may be persuasive, depending on the size and importance of the Tenant and the Premises and the condition of the market, is that the lender will usually want to preserve the project's income stream and avoid termination of the Lease in the event of a foreclosure. The counter-argument is that when a lender takes over a project that has ended up in foreclosure, re-Tenanting and realigning space and moving Tenants will almost certainly be required. If the Lease does not provide for a Landlord's right to relocate the Tenant, the lender still has the right to oust the Tenant in the absence of an NDA or provisions in the Lease protecting the Tenant. An alternative remedy for the Tenant (but not in a foreclosure) is reliance on the Lease covenant of quiet enjoyment. However, that covenant is often "watered-down" by the Landlord's Lease form, and if the Landlord is insolvent or a single purpose entity, even it would be of little help. Overriding all of these legal considerations is the Tenant's business decision as to whether the protections afforded by an NDA are important enough to risk losing the location. Further, even if the Tenant successfully negotiates with the Landlord, the ultimate protection can only be provided by the Landlord's lender; not all lenders will accept changes to their standard loan documents, which will usually not adequately protect the Tenants.

A Tenant's request for an NDA as a condition to the Lease will probably result in a lender's requirement for the Tenant to execute a Subordination, Non-Disturbance and Attornment agreement ("SNDA"). If the lender has recorded its loan prior to the Lease becoming effective, the Lease will, in most instances, already be subordinate to the loan. The Tenant's request for an SNDA should be part of any letter of intent between Landlord and Tenant. If Lease negotiations precede the recordation of the loan, the lender may insist on execution of an SNDA to protect itself even though the Lease is executed later. If a property is sold or refinanced, a new lender will probably require an SNDA to be executed by all Tenants in the project prior to closing of the loan, without regard to the provisions that appear in the Lease pertaining to the execution of an SNDA. The refusal of a Tenant to execute an SNDA when the Lease requires it can subject a Tenant to a damage claim if the Tenant's position is arbitrary or unreasonable and such refusal results in damaging the Landlord in the form of a failed sale or opportunity to refinance its ownership.

From the Landlord's perspective, the SNDA is a contract between the lender and the Tenant that subordinates the Lease to the security interest of the lender and allows the Tenant to continue in possession in the event of a foreclosure. Landlords typically are indifferent about SNDAs unless a sale or refinancing hinges upon obtaining an SNDA for the lender or for a new purchaser's lender. Obtaining an SNDA imposes an administrative burden on all parties. A Landlord's lender may refuse to provide the NDA in the absence of such requirements in the loan documents, but such a refusal risks losing a Tenant if the Tenant requires an NDA as a condition to the Lease. The lender will always seek more flexibility and may refuse an SNDA or NDA when a loan is already in place at the date of execution of a Lease, so that upon foreclosure, if the lender believes that the economic provisions of the Lease do not reflect market conditions (*i.e.*, the Lease is less favorable to the Landlord), the lender will not be bound by the Lease. The SNDA from the Landlord's perspective adds an additional level of complication to the Lease transaction, because the lender must approve the terms of the Lease. From the lenders perspective, the SNDA is a trade off to obtain or retain a good Tenant. The lender will generally agree to an NDA, provided the Lease terms are acceptable, but will insist that the Tenant's Lease be subordinate to the security interest of the lender and that the Tenant attorn to the lender.

Attornment is simply the process whereby the Tenant and lender agree to recognize the Lease as a direct contractual relationship between them, even though they were not the original contracting parties. The Tenant agrees to recognize the lender as the Landlord upon the lender taking title of the property upon foreclosure. The Tenant will likely insist that the lender agree to recognize and be bound by the terms of the Lease as a condition to the agreement to attorn to the lender.

Major Tenants sometimes attach a form of SNDA that is acceptable to the Tenant as an exhibit to the Lease. In the absence of such an attached SNDA, provision should be made in the Lease relating to the scope of the SNDA that the Tenant is willing to accept. As a practical matter, lenders will insist upon their own form of SNDA. However, if the form of the SNDA that is acceptable to the Tenant is attached to the Lease, there is at least an argument that the "reasonable provisions" that Tenants are often forced to acknowledge may be limited by the provisions that are contained in the SNDA attached to the Lease. If the Landlord has the opportunity to attach the

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lender's SNDA to its standard Lease form, presuming the lender will agree to the use of such a document, it should be included together with the provision that the Tenant will execute the form of the SNDA attached to the Lease together with such other provisions as may reasonably be required by the lender. This means that counsel must then review that document carefully when negotiating the Lease to be sure that the most onerous provisions are appropriately modified or deleted.

There are numerous provisions in an SNDA submitted by a lender which should be examined carefully from the Tenant's perspective. Certainly, certifying that the Lease attached to the SNDA is an accurate document, should not represent a problem. Since lenders often include estoppel provisions in the document, it is not inappropriate to agree that the factual statements are accurate (if they are accurate). The difference between agreeing to the facts stated in the SNDA and entering into "warranties and representations" regarding such facts can be significant, and Tenants should not agree to the latter. The Lease can be subordinated to the loan, provided the lender agrees not to disturb the possession of the Tenant so long as the Tenant is not in default beyond the period of notice and opportunity to cure provided in the Lease. Most SNDAs will require a Tenant to attorn to the lender in the event of a foreclosure. It is our practice to agree to attorn so long as the lender likewise agrees to be bound by the terms of the Lease. While this may not technically be necessary, it eliminates any argument about the subject and may be useful in the event of a dispute with the new Landlord, whether the new Landlord is the lender or the party to whom the lender sells the project.

The most difficult provisions involve the continuing liability under the Lease after foreclosure. It is important to acknowledge that any continuing breach of the Lease must be resolved after the lender forecloses, presuming the Lease has not been terminated by the Tenant as a result of Landlord's default. As examples, if such defaults are of a continuing nature, or if the Tenant has acted in accordance with the provisions of the Lease to obtain remedies provided by the Lease, and given notices as required by the Lease, such Tenant rights should survive foreclosure. It is appropriate to give the lender notice of any such Landlord default at the time that the Tenant notifies Landlord of such default, and many lenders will so specify in the SNDA. Be careful not to waive claims that relate to the Landlord's obligation to pay money to the Tenant, as for instance, Tenant allowances. Negotiating an offset right for monetary defaults of the Landlord is a cure for this problem as long as the SNDA does not prohibit it.

Lenders customarily prefer to have sufficient time to cure Landlord defaults so that they can foreclose the interest of the Landlord, and, if necessary, obtain relief through a bankruptcy court; this can extend the lender's cure period for a considerable period of time. In representing Tenants, it has been our position that such extensions constitute an extreme hardship on a Tenant and should not be countenanced. While major Tenants may be able to limit a lender's cure right to the same time period as given to Landlord to cure any Landlord's default, most Tenants will be forced to accept the fact that the cure rights of a lender will be extended for a considerable period of time.

Another controversial provision in SNDAs is the right of the lender to ignore any amendments to the Lease which have not been approved by the lender. While the loan agreement between the lender and Landlord may provide that all amendments to a Lease must be approved by the lender, that is a matter between the Landlord and the lender and a Tenant should not be subject to those provisions. Since there is no privity of contract between the lender and Tenant except for an SNDA and perhaps an estoppel certificate, those provisions in many instances are stricken if the Tenant has sufficient "muscle" to insist upon it.

Many Landlord Leases contain provisions limiting the liability of the Landlord to the extent of the asset that is subject to the Lease. This can be a problem where a single purpose entity owns the subject property, particularly if the Landlord fails to maintain the insurance required by the Lease. We suggest at the very least that an exception to the limitation on liability be created in the event the Landlord fails to carry the insurance required by the Lease. Limiting the lender's liability to the asset does not represent as much of a problem because when the lender forecloses, it will essentially own the property without debt. In the case of an overbid, debt may encumber the property but an equity requirement is likely which will give recourse to a Tenant who has claims, unless such claims are waived, as part of the SNDA. Better practice is to strike the provisions limiting Landlord's liability, although the strength of the Tenant may be the determining factor in those negotiations. When a Landlord refinances the property and pulls all of its equity out, the likelihood of foreclosure may increase. From the Tenant's perspective, there is no apparent reason to limit Landlord's liability in the instance

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of ownership by a single purpose entity.

From a Tenant's perspective it is also important to provide that the lender will make available the proceeds of condemnation and/or insurance necessary to restore the Premises and/or the project in the event of an insured casualty rather than to simply permit the lender to utilize the proceeds for its own purposes.

Lenders and Landlords may also require periodic execution of estoppel certificates by Tenants. It is a good practice to make the estoppel provisions of a Lease mutual so that in the event of a sale of the Tenant's business, it will be possible to obtain an estoppel certificate from the Landlord on the same basis that such estoppel certificates may be required from a Tenant in the event of a sale of the project of which the Premises are a part. Attaching the form of an acceptable estoppel certificate to a Lease makes sense for the Tenant on the same basis that attachment to the Lease of a form of SNDA is appropriate. The purpose of the estoppel certificate is generally to state a set of facts that the parties agree represents a current state of affairs. The estoppel agreement should not modify the Lease and the representations should be limited to "Tenant's knowledge" or "Tenant's knowledge without investigation" as to issues pertaining to Landlord's default or facts that would result in a Landlord's default.

As you can see from this discussion, a Tenant's request for an NDA can result in complications relating to the provisions of an SNDA. Neither the SNDA nor an estoppel certificate should be taken lightly. They should be reviewed carefully by counsel so that unintended consequences are avoided. BW

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expanding the scope of the liability owed by every Landlord to every one of its Tenant's contractors, but did not.

The question now for commercial property owners is the following: How do they now protect themselves against their Tenant's contractor's claims? Because a contractor's waiver of its subcontractor's constitutional mechanic's lien rights are unenforceable (*Civil Code* § 3262 (a)), the owner is left with limited choices, which include:

1. Require all persons (*e.g.*, Tenants) contracting for work to be performed on the Premises to obtain a surety payment bond in favor of the Landlord in case of non-payment from the Tenant to the contractor (note that this will also likely add from 0.5 to 2% to the TI contract price);

2. Require that the Tenant use a contractor chosen by the Landlord, or the Landlord will perform the construction itself (*i.e.*, through its own contractor);

3. Require that the Tenant pre-pay the entire TI contract amount to the Landlord, including the Landlord's management fee, to ensure that the Landlord has funds sufficient to pay the contractor at the conclusion of the work;

4. Ensure that a sufficient third party guarantee is in place which attaches to all obligations of the Tenant related to the Lease and the Premises, specifically inclusive of all mechanic's lien obligations which may be asserted against the Landlord for third parties' works of improvement performed on or at the Premises;

5. Require the general contractor to waive or release all claims against the Landlord for any non-payment to him by the Tenant (See *e.g.*, *Santa Clara Land Title Co. v. Nowack & Assoc.* (1991) 226 Cal. App. 3d 1558, 1568); and/or

6. Require that the Tenant include in all construction contracts for the Premises that all contractors, subcontractors and materialmen provide lien waivers and releases under *Civil Code* § 3262 to the extent payments are made to them and ensure that the Landlord is copied on all invoices, payments, and lien releases. The Tenant's later failure to require and obtain these releases on a regularly scheduled basis (*e.g.*, monthly) would then constitute a breach of the Lease and a cause for eviction and stoppage of the work.

7. Include a provision in the Lease and in a side agreement with the general contractor that the Tenant and contractor cannot accumulate debt from the Tenant to the contractor of more than one-half of an amount set aside in the Landlord's account as collateral for the debt.

With the current demise of the ability of a Notice of Non-responsibility to act as protection for a Landlord from a claim from an unpaid Tenant's contractor, the knowledgeable and cautious building owner must take extra and indeed extraordinary measures, over and above serving and recording a Notice of Non-Responsibility, to protect itself from its Tenant's contractor's, subcontractor's, and materialmen's claims. BW

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the date of the walk off, including all profit, have been created by contractors to further protect themselves from a non-payment situation. In larger projects, contractors, much like owners, now require the posting of a payment bond to ensure that they will be paid.

While most people in the construction industry agree that the traditional protections are adequate to ensure payment, the California legislature enacted *Civil Code* §3110.5 to further protect contractors from non-payment by requiring owners to post certain security under certain defined scenarios. In summary, *Civil Code* §3110.5 provides that non-exempt owners of commercial real estate construction projects with a cost in excess of $5,000,000, or owners of less than a full interest in such projects with a cost in excess of $1,000,000 (*i.e.*, tenant improvement projects) must provide and maintain security for the payment of the contract amount in one of the following forms: (i) a payment bond; (ii) an irrevocable letter of credit; or (iii) a construction escrow account. The amount of the security is 25% of the contract amount for projects scheduled to be completed within six months, and 15% of the contract amount for projects scheduled to be completed in excess of six months. Furthermore, if the requirements of *Civil Code* §3110.5 are triggered, then the owner must provide the contractor with a certified copy of any construction mortgage or deed of trust indicating the amount of the loan.

Exemptions

1. Ownership in Construction Company. In the event the owner of the real property is also a majority owner of the construction company, the requirements of *Civil Code* §3110.5 do not apply.

2. Public Companies. Companies who are publicly traded on the New York, American or NASDAQ stock exchanges and whose debt securities are rated investment grade, are exempt from *Civil Code* §3110.5. Additionally, an owner is exempt if it is a wholly owned subsidiary of a qualified company and the parent company guarantees the obligations of the subsidiary.

3. Private Companies. A private company with a net worth in excess of $50,000,000, as long as the net worth is calculated pursuant to generally accepted accounting principals.

Requirements of Security

The 15% or 25% security amount is based on the fixed price, guaranteed maximum price, or the parties good faith estimate of the contract amount (applicable in a time and materials contract). The security may only be applied by the contractor when the owner defaults on his or her contractual obligations to the contractor. The language seems to leave open the question of whether the contractor can apply the security in the case of a default other than non-payment of the construction contract.

Forms of Security

1. Payment Bond. If an owner is subject to the requirements of *Civil Code* §3110.5, and is not able to avail itself of an exemption, one option is to purchase a payment bond in favor of the contractor. Generally, payment bonds cost in the approximate range of 2% to 3% of the construction contract amount and, therefore, the requirements of *Civil Code* §3110.5 can be expensive to an owner and significantly drive up the costs of construction. The payment bond must provide that it is payable to the contractor upon default by the owner of any disputed amount under the contract that has been due and payable for more than 30 days.

2. Letter of Credit. If an owner is subject to the requirements of *Civil Code* §3110.5, and is not able to avail itself of an exemption, another option is to post an irrevocable stand by letter of credit provided by a financial institution as provided in *Financial Code* §5107. The specific terms and the maturity date of the letter of credit are left in the statute to the parties to determine. The letter of credit must be maintained until the owner has satisfied all of its payment obligations under the construction contract. Because the terms of the letter of credit are left to the parties, this mechanism for complying with *Civil Code* §3110.5 is the most flexible.

3. Escrow Account. If an owner is subject to the requirements of *Civil Code* §3110.5, and is not able to avail itself of an exemption, then the creating and funding of an escrow amount will satisfy the requirements of the statute. The escrow holder must be properly licensed or exempt from such requirements. The owner must satisfy the contractor that the contractor has a perfected, first priority security interest in the construction escrow account and all funds deposited therein. The funds are to be distributed only upon written authorization from both the owner and the contractor. Because this type of construction security requires the good faith participation by both parties, it is subject to abuse. Mainly, an owner who may in fact owe the money in the escrow account due to its default may refuse to authorize the draw on the escrow account, trumping the purposes of *Civil Code* §3110.5. In the event the owner is withholding "retention" amounts, such funds must also be deposited into the escrow account. The funds in the escrow remain the property of the owner. Therefore, the funds are returned to the owner upon completion of the project, and the owner discharging all payment obligations under the construction contract.

Pros and Cons of the Types of Security

From the owners' perspective, a payment bond will drive up the cost of construction. However, owners may be somewhat comfortable with this concept because sophisticated owners generally require payment bonds from their contractors to ensure against mechanic's liens. Additionally, the criteria in the statute regarding a draw on the bond is somewhat more clear than the other security devices authorized by the statute. In the context of the payment bond, the contractor can make demand upon the bonding company upon the occurrence of an "event of default." The key question is "When is the owner in 'default,' and do the parties agree that an 'event of default' has occurred?" Obviously, the owner will dispute the claim on the payment bond if it believes that it is not in default of the construction contract. Whether a default has occurred is a key component of whether the demand on the bond is proper and whether it is contested by the owner.

The letter of credit may be the most attractive form of security to be posted by the owner. First, it is the most flexible because the statute does not address the formal and technical requirements of the letter of credit. Second, a reputable owner should be able to secure a letter of credit in the required amount based on its banking relationship without posting any additional cash security. Lastly, if the owner has a construction lender, it can likely have that lender issue the required letter of credit as part of the loan package.

The escrow account may be the security device most subject to abuse. Much like any escrow account, issues arise regarding the ownership of the escrow funds and who is entitled to the funds. The escrow holder generally cannot resolve these disputes and is left in a position where it cannot distribute the funds to either party. An interpleader action, where the escrow holder requests that the court order distribution of the funds, is generally filed by the escrow holder if the parties do not first sue each other and the escrow company. Three-party litigation as to the escrow funds is likely to follow a dispute related to a controversial or disputed claim as to the escrow funds.

Failure to Comply with Statute

Civil Code §3110.5 does not contain a statutory penalty for failure to comply. Instead, a contractor can simply stop work on the project and demand compliance with the posting of security requirements of *Civil Code* §3110.5. Therefore, it is generally believed that owners and contractors can agree to ignore the requirements of *Civil Code* §3110.5; however, the contractor can demand compliance at any time, and stop work until compliance has been accomplished by the owner.

Conclusion/Recommendations

The requirements of *Civil Code* §3110.5 will drive up the costs of construction and leave open a new area for disputes and litigation between an owner and contractor. Mechanic's lien law and other statutory schemes generally provided contractors with security for the payment of the contract sum. The new *Civil Code* §3110.5 provides an additional layer of security to contractors that may be unnecessary and overburden the construction process. For those who are not exempt, a variety of methods are available to an owner to comply with the statute. Owners must carefully consider which method of security is most appropriate under each circumstance. Consultation with knowledgeable counsel can assist an owner or contractor with compliance with *Civil Code* §3110.5 and provide creative solutions to minimize the impact the statute has on a project and the associated costs. BW

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the Napa Valley, and then some.

My law partners here at Berding & Weil LLP, knowing that I represent and have ownership interests in vineyard properties and wineries in Napa Valley, have asked me to address some of the many aspects to be considered in buying and developing vineyards and wineries in Napa Valley, California. I plan to write a series of articles in the ALERT, providing general information about this subject area. This first article will be limited to just some of the considerations in getting a vineyard started. Please understand that I have painted with a very broad brush; these remarks are not meant to be a "how to do it"! This first article emphasizes some of the contingencies used as conditions to the close of escrow that are peculiar to vineyard property acquisitions.

Obviously, the initial step is to locate an appropriate property. With all the new plantings over the last ten years, good viticultural land in the Napa Valley is extremely hard to find even at historically high prices. The search usually begins through the use of a real estate broker or vineyard consultant; however, vineyard farming management companies, Napa Valley CPAs and banks can also be great resources through which to access vineyard land opportunities.

Once an available vineyard site is located that appears acceptable, a purchase and sale contract should be entered into with the landowner. In addition to the normal conditions precedent that would be present in any real estate purchase agreement that must be satisfied or waived prior to the buyer being obligated to purchase, the following additional contingencies should be added to the contract or satisfied by the buyer:

1. **Satisfactory Soils Report and Analysis**: This report is necessary to determine whether the soil and its components and the levels thereof (boron, iron, etc.) are consistent with the farming of the particular intended varietal at the site. This report will also address a wide variety of factors, including the percolation of water through the soil and the speed thereof; good drainage will keep the roots healthy, which, of course, helps produce better fruit.
2. **Satisfactory Water Analysis**: Available reservoir, lake, well or stream water will be analyzed both for how much of the year it is available, at what depth, its quality and with respect to a well, at what rate the well will deliver water for the vineyard needs. There is new pending legislation in Napa County, which will dictate how near a creek or stream a vineyard may be developed and certain other development restrictions. It is only one of the many proposed changes in the law that has been, and likely will continue to be, sponsored by the environmental interests in an effort to protect nature.
3. **Satisfactory Well Analysis**: If there is no well, an analysis is required from a hydrologist to determine where the water is located on the property, water table levels, historical data and the rate at which it is estimated that water may be pumped from a well for both irrigation and frost protection. My wine partners and I have even used "witches" with their divining rods to help us on certain properties; these witches are quite accurate, and they are in common use in the Napa Valley.
4. **Satisfactory Wind and Breeze Analysis**: This contingency factor may seem supercilious, but, in fact, there are very well-known wind and breeze patterns throughout the Valley, and their location, frequency, force, direction and mean moisture content are critical to some vineyards. Simple anecdotal evidence is relied upon by some purchasers.
5. **Satisfactory Weather Studies**: The results of such studies will dictate the type of root stock, clone and varietal to be utilized. To develop this data for one of our acquisitions, we utilized satellite reads on the subject property that were made from space (with an antenna on the property) with the results then transmitted to our personal computers. Here is just one example of how the results of these studies may dictate action: if they show that there is an inversion layer (warmer air) above the site, wind machines can be purchased and installed for about $17,000 each, which will help avoid loss of the crop to frost.
6. **Investigation of Current and Historical Use of Adjacent Properties (or even nearby)**. If there are vineyards planted on adjacent properties, the buyer will want to know the varietals that have been planted there, on which root stocks and clones and just what the yields have been. Normal vineyard yields are about four to five tons per acre.
7. **Investigation of Current and Historical Existence of any Pests**: The buyer will want to know whether there is any phylloxera, glassy-winged sharpshooters, etc., on, at or near the property, or varmints (gophers, deer, rabbits, etc.) that frequent the property or nearby or adjacent properties. These microbes, insects and animal pests can wreak havoc on a vineyard. The phylloxera microscopic

"bug" devastated the Napa Valley and Sonoma County and elsewhere during the late 1980's and early 1990's. Vineyard owners spent hundreds of millions of dollars on an aggregate basis to rip out and replant diseased vines and take other eradication measures.

8. **Determination of the Slope of Property**: There is a very tough hillside ordinance in Napa County that must be carefully followed. If the property qualifies, the ordinance will require among other provisions the filing of a soil erosion plan. The criteria as to whether the property will be subject to the ordinance are based on the vertical slope of the property. Any vineyard developer, who does not follow this ordinance and CEQA, where applicable, runs the risk of the County "red-tagging" the vineyard and essentially shutting it down. One recent very hot topic in the Valley was whether environmental impact reports (EIR) are required before the County may properly issue use permits for vineyard development.
9. **Determination of Availability of Friendly Adjacent Neighbors**: The old notion that "good fences make good neighbors" is only part of the equation. A friendly neighbor, who is also a vineyard owner, can be an invaluable ally to the vineyard developer and a great source of data, and maybe a potential partner to share vineyard security and farming costs. Also, it never hurts to have another set of eyes to monitor vineyard activities.
10. **Satisfaction that Zoning Entitlements are Available**: Obviously, the property must be properly zoned for agricultural purposes and any required use permit and other entitlements must be reasonably available at reasonable costs if the vineyard is to be developed within a reasonable budget and within a reasonable time period. A determination should be made to see if the property will qualify for tax relief under application of California's Williamson Act and other agricultural tax relief laws.
11. **Approval of a Farming Report**: This Report will help the potential buyer determine the cost of developing the property. It should be issued by an experienced and competent farm management company that has substantial experience in vineyard farming in the immediate area.
12. **Approval of Samples**: Sampling and approving any wine made from adjacent or nearby vineyard properties having essentially the same characteristics as the subject property will provide a very good idea of the quality of the fruit that the property is likely to produce. If the buyer has selected its eventual winemaker this early, or has a winemaker consultant with whom to confer, it would be wise to obtain that winemaker's opinion of such wine.
13. **Satisfaction regarding Ingress and Egress**: It is essential to know exactly where the legal ingress and egress to the property is located to make sure that there is the correct amount of area sufficient to allow farming equipment the space it needs to operate.

Assuming these contingencies have been satisfied, approved or waived, the purchase will then proceed through the normal California real estate closing procedures. While the escrow fees, title insurance premiums and other escrow costs are about the same in a vineyard transaction as in any other commercial real estate purchase, the buyer will have the added due diligence costs to satisfy the above contingencies. The seller will likely pay about a 10% real estate commission.

A successful close of the purchase of the property, and assuming the root stock and clone have already been selected and ordered, the next step is to plan the layout of the vineyard. It is important to hire a very experienced vineyard management company to walk the property with you, observe the contours of the land, how adjacent or nearby vineyards are laid out, the proximity of surrounding hills and forestation, the movement of wind through the area and surrounding hills, if any, and a wide variety of other factors. The next step is to decide on the type of irrigation system (drip or sprinklered)

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and frost protection that should be installed and the type of trellising to be utilized. The trellising employed is the support mechanism on which the vines will grow, and its selection is extremely important, because it is the trellis design and the pruning method that determines whether and when vines will properly grow and produce good fruit. A well-designed trellis system and proper pruning will assure that the appropriate amount of sun, shade and water reach the fruit and leaf and that a proper flow of air moves through the vines.

After the irrigation, frost protection and trellising plans have been decided upon, the soil must be prepared for planting. The soil must be tilled and all large objects removed, such as boulders, and a drainage system installed, if necessary. In some cases, various soil amendments must be utilized to offset minerals in the soil (i.e., gypsum to combat boron, etc.). Then, the vineyard must be staked (per the vineyard layout plan), the trellises must be installed, the irrigation system and frost protection installed and the vineyard planted.

The planting of the vineyard may occur as early as spring, or as late as the end of summer, dependent upon the soil, water, elevation, the type of varietal and clone (early vs. late budding) that are being utilized, and, of course, the weather and geological surroundings. It is very important that a viticultural expert be hired to assure that the right varietal is being planted in the correct location in the correct vineyard and at the right time of year. My partners and I use an expert that is affectionately known as "Doctor Dirt." He can almost advise you by looking at a map, because of his vast experience. It doesn't matter how good one is in business, when it comes to vineyard development, as in law, you need experts.

Once the vineyard is planted according to plan, it must be monitored and nurtured on a constant and continuing basis to assure the highest possible yield *and quality* from the vineyard. The first crop ("leaf") can be expected by about the third year with full production by the fifth leaf. Yields vary by any number of factors, but an average range will be about four to six tons of useable grapes per acre. One ton of grapes is equal to about sixty cases of wine. BW

Editor's Note: *Robert L. Young's practice areas at Berding & Weil LLP include commercial real estate, corporate and business law, turn-around endeavors and the negotiation and structuring of a variety of transactions, including those involving the wine industry. Berding & Weil LLP represents vineyard and winery owners, both in their normal business endeavors and in the acquisition, financing and development of vineyard and winery properties. Mr. Young will write future articles in this area, again keeping the content as he has said, "…painted with a broad brush".*

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