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COMMERCIAL REAL ESTATE ALERT

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ADDRESSING THE NEEDS OF COMMERCIAL REAL ESTATE PROFESSIONALS

California Vineyards

"The Next Step"

BY ROBERT L. YOUNG, ESQ.

THIS IS THE FOURTH in a series of articles. In my first two articles for the *Alert* I wrote about "Development of Vineyards in Napa Valley, California". Those articles focused on the development of a vineyard from "raw" land (*Alert* June 2003) through the vineyard as an annual renewable resource and an annual income-producing asset (*Alert* December 2003). In each article I have written about a hypothetical vineyard. In my March 2004 *Alert* article, consideration was given to whether, when and how much wine should be made for sale from the hypothetical vineyard. It would be helpful to the reader to review these prior articles to understand the significance of this one. Remember, our farmer's vineyard is located in Napa County, California, and only cabernet sauvignon grapes are grown. Also, Remember, that the terms "grower", "vineyard owner", "owner" and "farmer" all refer to the owner of our hypothetical vineyard. At the conclusion of the last article our vineyard owner had decided to follow the consultant's advice and to initially sell more grapes than are retained for winemaking. The idea was to slowly, over a 5 to 7 year period, reverse the equation, so that more grapes were used for winemaking than were sold to wineries.

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Letters Of Credit

Are They Still An Effective Shield Against Tenant Bankruptcy?

BY ERIKA D. HARRINGTON, ESQ.

IN THE LATTER PART OF THE 1990's, some landlords constructed entire campuses for relatively unknown dot com tenants. However, in recent years, many of these seemingly unstoppable tenants filed for bankruptcy protection, leaving landlords holding only a security deposit.

Once a tenant files for bankruptcy, the Bankruptcy Code limits a landlord's claims against the tenant for prospective damages resulting from the lease termination to the greater of (a) one year's rent under the lease, or (b) fifteen percent (15%) of the rent due during the remaining lease term, up to three years. (11 U.S.C. § 502(b)(6)(a)). Therefore, Landlords who hold greater than one year's rent in a security deposit are generally forced to surrender the excess if the tenant files for bankruptcy.

Letters of Credit (or "LCs"), however, have generally been unaffected by a tenant's bankruptcy filing. Due to a concept long cited by courts as the "Independence Principle" (explained in more detail below), courts have in many instances allowed landlords to draw on a LC despite the tenant's "debtor" status and in amounts in excess of the statutory cap imposed on prospective damages.

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The farmer's thought (based on the consultant's advice) was that if this strategy proved successful, eventually all grapes would be retained for winemaking. We now leap ahead seven years. The farmer has been very successful in building a brand ("Newco Ridge"), building inventory, establishing distribution channels and selling almost 100% of each vintage produced. At the end of the fifth year all grape sales to wineries ceased. The farmer allowed all grape contracts with wineries to expire.

THE TEASE

Now, in 2004, eight years since the vineyard achieved full production, the grower has the 2002 vintage for sale and the 2003 vintage in bulk (wine in the process of being made). While all the wine released each year through the 2001 vintage was successfully sold, the owner has had no grape sales income for two years. Our owner is, therefore, anxious to sell the 2002 vintage through the established distribution network. As you will remember, the grower had established three distribution channels:

(1) sales directly to California consumers through a mailing list and a wine club he had developed from such a list;

(2) sales directly to California restaurants; and

(3) sales through distributors and brokers.

The consultant (March 2004 *Alert*) had been correct in the assessment of the quality of the owner's grapes and the wine that was made from it. The vineyard owner's sales through all three outlets have been successful. Sales each year have increased equal to whatever the farmer's inventory could supply. The fact that the grower had been bringing Newco Ridge wine into the market place incrementally (again, as recommended by the consultant) was also paying off. Very good wine and a very short supply relative to the demand were, of course, increasing demand. As the owner reviewed the three distribution channels, it was clear that the entire 2002 vintage in inventory could be sold in one year or less through this network. As a result, three thoughts occurred to the grower: (1) if everyone loves my wine so much, maybe I should substantially increase the prices; (2) why don't I sell as much of my wine as I can direct, first, and then whatever is left over I'll sell to the restaurants ("House Accounts"), distributors and brokers; and (3) why not go all the way and sell 100% of my wine direct at retail and through my own retail outlet (a tasting room). To answer these questions, the owner again calls on the consultant who gave such good advice some years earlier.

After listening to an update from the vineyard owner and asking key questions, the consultant advises as follows as to the three questions:

PRICE INCREASE?

Over the years the vineyard owner passed on any cost increases incurred in the vineyard and in winemaking costs and always maintained a profit factor. The consultant points out that while a nominal price increase may be warranted, a substantial increase would be unwise. Over the past 7 years there have been only nominal price increases. The consultant advised that it was not just the quality of "Newco Ridge" that had made it so popular, but its price point! It was very affordable. The wine industry has just finished selling the excess supply that had existed over recent years, and the phenom of the "2 buck chuck" competition has had its effect. To attempt to move the price too much at this critical juncture ran the risk of alienating the consumers, restaurants, brokers and distributors. After some discussion, the owner agreed on a new modest price increase, but it was not to be implemented for a few months until the 2002 vintage was already well received and sold in the market place. The consultant also cautioned that non-retail sales channels (distributors, brokers and restaurants) do not like surprises when it comes to price increases. The grower was advised to notify them well in advance. The owner was told that such a notice would likely increase cash flow on a short-term basis, as the wholesale accounts ordered to capture the old prices.

RETAIL FIRST-WHOLESALE SECOND?

The consultant did not like this idea at all. The grower was cautioned "...that while you may have a short term gain by selling as much of your wine as you can at retail and only using wholesale as a secondary channel, there is always the inevitable glut, general economic downturn, inflation, poor crop year, unemployment and a wide variety of other factors that will surely occur in the future that will substantially curtail retail sales. Further, your distributors, brokers and restaurants will view your decision as a slap in the face. You used them to build your brand and then terminated their supply once you were successful. Those distribution channels have long memories. When tough times for retail return (and they will) and you come back to the distributors, brokers and restaurants to sell Newco Ridge, you may not receive return phone calls." The consultant tells the grower that it is always a balancing act in determining just how much wine should be sold at retail, enjoying higher margins, and how much should be sold at wholesale with the lower spread. The grower was encouraged to be fair to both so that in good times and bad times, Newco Ridge would always be able to sell 100% of its wine. The owner asks about the wineries that sell out their entire inventory every year at retail. The consultant responded that there are only a few wineries that are in this category that have developed an almost cult-like following. They tend to be boutique (very limited production), and they often have a "rock star" name as the winemaker. Those wineries also usually have quite a history of highly rated wines written up in the trade publications. The farmer realizes that while the Newco Ridge operation is boutique, and it has had some good press, it is not yet in this category.

MY OWN RETAIL OUTLET?

Before answering this question, the consultant made it clear that:

(1) Because of the very restrictive rules about ownership of production, distribution and retail sales (resulting from the repeal of Prohibition), the only way for the grower to own a retail outlet would be to build a winery. If the farmer owned a licensed winery, he could conduct retail sales at the winery's tasting room (if it had one) or at a retail store off the winery premises, or he could do both.

(2) The consultant's advice would be predicated on and limited to the farmer's situation. It was not meant to be applicable to every vineyard owner contemplating a retail outlet.

Since the only way for the grower to own a retail outlet was to first own a winery, the consultant said they should devote their analysis to whether building a winery made any sense at this time. As the owner and the consultant thought through all the pros and cons, they agreed to assume that if a winery were built, the retail outlet would be a tasting room located at the winery. They decided to keep track of the arguments for and against building a winery for later analysis.

PRO

- Retail sales from the tasting room would mean higher gross sales on less volume.
- A tasting room would provide a controlled environment where only Newco Ridge would be sold at retail.
- Consumers would be able to sample and taste before they purchased.
- The tasting room employees would be incentivized to sell as much Newco Ridge as possible.
- The tasting room manager would have a captive audience to not only sell wine on the spot, but would also provide the one-on-one opportunity to enroll additional consumers in the Newco Ridge wine club.
- Quality control could better be maintained since the employees and the winery's facilities would be (at one location), under the total control of the owner and the winemaker.
- Savings could be effected in transportation costs, because grapes would move directly from the vineyard to the winery for processing rather than to a winery at some other location for processing and storage. Most of the wine (bulk and finished) could be stored at the winery and much of the shipping could occur from there.

Scheduling of harvesting and bottling could be more fine-tuned to suit the requirements of the vineyard and the winery rather than the farmer being at the whim of a third-party winery. The wineries usually dictate by contract or otherwise at what point they will receive the harvest. There would be no middle man (a custom crush facility) deciding when and how harvesting and bottling would occur based on its schedule and those of competing wines.

CON

- Obtaining the entitlements would be extremely difficult and costly.
- If entitlements are obtained, there is the time, money and frustration in building a winery and equipping it.
- The need for additional employees, which, of course, would mean a higher expense factor (salaries, employer's share of payroll taxes and benefits) and the cost of additional training and supervision.
- Increased non-employee costs of owning and operating a winery (utilities, licenses, insurance, real estate taxes, accounting and legal, compliance, etc.).
- Increased break-even point (higher sales required).
- Maintenance, repairs and replacement costs of plant and equipment.
- Additional time required to market the tasting room (in addition to the wine), so another profit center is created and the "lag" time necessary to mature the tasting room.
- The owner would not just be growing grapes and selling wine, but would also have yet two more businesses to manage: a winery, a retail outlet and the people necessary to staff them.

In the consultant's opinion, it was a very close question of whether the vineyard owner should take on all this additional headache and proceed to this next step. After discussing all the pros and cons with the consultant, the farmer agreed that it may not be worth all the extra stress. However, our ever-optimistic grower asked the consultant to discuss the major items that would cause that stress if a decision were made to proceed to build a winery. The consultant was asked to keep it simple, assume a tasting room rather than an off-premise retail store and describe things in general. The consultant agreed. The grower could always get the details later if a decision was made to build a winery.

The consultant indicated that there were three phases to such a project:

(1) Entitlements

(2) Construction of the Winery

(3) Opening and Marketing of the Tasting Room

ENTITLEMENTS

"It is almost impossible to get a winery license today in Napa County." This was the consultant's lead remark. With the ever-increasing awareness of environmental concerns in the Napa Valley along with more and more tourists and full-time residents (traffic and congestion) living in the area, the County has become quite reluctant to grant use permits. A use permit is required by the County to use the property as a winery. It must be obtained before construction may commence. There are various restrictions already on the books relating to all real property in Napa County, and the first question is whether the property's zoning allows for the operation of a winery on the property. The grower had already checked the zoning and knew he was okay. After zoning, there would be a myriad of issues to be addressed to the County's satisfaction to obtain a use permit:

(1) Is the winery's proposed location near a school or a hospital or a residential area?

(2) Is there an existing public road providing access to the proposed location?

(3) How far from a public access street will the winery be located?

(4) How many gallons of wine will be made at the winery each year?

(5) Will the winery cause any material increase in traffic, noise or congestion?

(6) Will the habitat of any protected wild life be affected?

(7) Is an Environmental Impact Report required?

(8) How many public and private events will be planned at the winery?

(9) What will be the hours of operation?

(10) Do the neighbors have any objections to the proposed project?

(11) The size of the winery and its design will have to be approved.

(12) What requirements, if any, will the fire department, water district and public works department demand?

(13) Is there sufficient area available to satisfy parking requirements?

(14) Are there any easements that are necessary for signage or to gain public access to the winery?

(15) Will visitors be required to make appointments?

After the owner's look of surprise subsided, the consultant said, "...the list goes on and on...". The use permit process can take six (6) months to 24 months or longer if there are appeals and mitigation elements to work out. The consultant advised that if the grower were ever to decide to seek a use permit that making friends with neighbors in all directions was very important. They could be the biggest impediments or the biggest supporters. The various County departments, of course, have their requirements. The consultant also reminded the owner that there is a growing movement in the Napa Valley to stop the grant of all future winery use permits and to severely restrict those that are granted. The farmer was told that the concerns of neighbors and mitigating their objections to the satisfaction of the County would likely be the area where the most time and money could be lost and spent respectively in the entitlement process. There would also be the costs of hiring engineers, architects, soils experts, hydrologists, environmental experts, landscape architects, attorneys, land use experts, etc. At this point, the grower sat down, opened a bottle of Newco Ridge, poured a glass and told the consultant to assume that the use permit would be granted and asked the consultant to describe the balance of the phases.

CONSTRUCTION OF THE WINERY

The consultant's principal advice here was that the owner hire a contractor who was experienced in building wineries. The contractor should be bonded, and there must be a written construction agreement. The written agreement should provide for progress payments against lien releases for all work completed up to the particular progress payment. All change orders (changes to the plans and specifications agreed upon by the owner and contractor) must be in writing. The plans and specifications for not only the winery building, but also for the equipment to be installed should be reviewed constantly. It is very easy to be misled by contractors, the architects, engineers, etc., who are not concerned about the costs of their recommendations. The consultant also cautioned against letting the architect and contractor make the major construction decisions. Someone should serve as the owner's eyes and ears to supervise the construction. The consultant cautioned that even with proper supervision, there are often cost overruns, but, at least, they could be kept to a minimum. The construction agreement should provide for a retention amount, so that there is a fund (maybe, 10%) of unreimbursed draw requirements that the owner may hold back until the winery is substantially built according to the plans and specifications. No final payment should be made until there is a final sign-off by the County that all conditions of the use permit have been satisfied, and by the ABC and the ATF, that the facility is approved for operation. Further, no final payment should be made until the local title company assures the owner that there are no mechanics or other liens recorded against the winery as a result of the construction. Since the winery would likely be small (20,000 gallon license), the consultant advised that there was plenty of used equipment that could be purchased for a fraction of its retail price. Assuming a relatively small winery facility, the consultant then educated the owner about the approximate cost of construction and of the equipment that would be needed for even a modest operation. The consultant also explained that perhaps only 60% of those costs might be financable through an institutional lender.

OPENING AND MARKETING THE TASTING ROOM

"It is going to take time," the consultant admonished. Do not plan on immediate tasting room sales. Even though the public knows the Newco Ridge brand and likes the wine, the tourists and other visitors to the Napa Valley have to learn about the winery's location. The owner is advised that it will likely take a few years for tasting room sales to stabilize. This is true for all new wineries. For several months before and after the tasting room opening, there should be a concentrated marketing effort. Bed and Breakfast establishments, tour operations, limousine companies and other wineries must be contacted and encourage to refer/bring their customers to the winery. The existing wine club membership should be heavily marketed to encourage them to visit the tasting room. Incentives work very well here to get the process started. Of course, once the winery and the tasting room are established, there will be the ongoing management and operational issues each year. The consultant shortened the explanation of this phase, because he could see the farmer was growing weary.

CONCLUSION

It was clear to the owner that the resources to build a winery and tasting room (and buy and install equipment) even with borrowing, were not available. In addition to all the costs and expenses that the consultant mentioned, there would also be a variety of additional costs that would have to be incurred to get the winery and tasting room open. The total of all of these expenses was way too much for our grower. A decision was made to wait until the farmer could afford the winery and all of its associated costs and expenses............ or until the grower learns (maybe from an article) about alternative financing arrangements to fund the winery's development. BW

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. In Mr. Young's first article in the *Alert* (June 2003), he provided a brief overview of the development of vineyards in Napa Valley, California and in his December 2003 *Alert* article he wrote about the vineyard as an annual renewable resource. In the third *Alert* article (March 2004), he wrote about some of the various factors that had to be considered by a vineyard owner in deciding whether to make wine. In the foregoing *Alert* article, he has written about how to make the grower's already successful winemaking business more profitable through price increases and/or the construction of a winery and tasting room and whether or not it was financially feasible for the vineyard owner to do so in the foreseeable future. These articles and future articles will lead the reader through an evolution of the dream of vineyard and winery ownership, and possibly beyond.

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However, recent case law casts doubt on the whether landlords can rely on this "Independence Principle" any longer. This article first explains why letters of credit have been a popular replacement for the traditional cash security deposit with landlords and tenants alike and then analyzes whether the recent case of *Redback Networks, Inc. v. Mayan Networks Corp.* will threaten the reliability of their use in the future.

LETTERS OF CREDIT

A Letter of Credit is an agreement between the landlord and the tenant's lending institution which allows the landlord to draw on a line of credit upon the occurrence of some pre-agreed event (most commonly some form of tenant default under the lease). Historically, LCs provided an attractive alternative to a cash security deposit from the perspective of both the landlord and tenant. A tenant who has a good relationship with its bank can often post only a fraction of the value of the LC, and in turn the landlord is often able to get a larger security posted on its lease. However, for landlords, the most significant benefit of the LC is that it has traditionally been treated by courts as separate from the bankruptcy estate of a debtor tenant.

The rationale behind the "Independence Principle" is that the LC is an independent obligation between the issuer (the lending institution) and the beneficiary (the landlord), and therefore is separate and distinct from the lease obligation between landlord and tenant. Thus, any dispute between the landlord and tenant does not affect the bank's obligation to pay on the LC when requested by the landlord. Courts have widely interpreted this Independence Principle to exclude LCs from the assets of a tenant/debtor's bankruptcy estate. This is important for several reasons.

First, LCs have been held not to be subject to the "automatic stay" imposed by the court when the tenant files for bankruptcy protection. This automatic stay freezes all litigation against the tenant and its assets (including the lease) leaving the landlord powerless to proceed with eviction or a traditional breach of contract claim in state court during the pendency of the bankruptcy. LCs, however, can in some instances be drawn on by the landlord despite the fact that the automatic stay has been imposed by the bankruptcy court.

Second, it was in many instances held that a LC would not be subject to the damage award cap imposed by § 502 (b)(6) of the Bankruptcy Code as noted above.

However, the United States Bankruptcy Appellate Panel of the Ninth Circuit, in the case of *Redback Networks, Inc. v. Mayan Networks Corporation*, 306 B.R. 295 (9th Cir. B.A.P. 2004), recently upheld a lower bankruptcy court's ruling that a landlord's draw on a LC should reduce that landlord's claim allowed under § 502 (b)(6).

THE *MAYAN* CASE

The facts in the *Mayan* case were as follows. Redback entered into a sublease with *Mayan*. *Mayan* posted a cash deposit of approximately $350,000 and a LC for almost double that amount. *Mayan* later filed for Chapter 11 relief and rejected the lease. The Landlord drew the full amount of the LC. The issue of the case was whether the Landlord's draw on the LC should reduce its allowable claim under § 502 (b)(6) or whether the LC would be considered a separate obligation (under the Independence Principle) between the Landlord and Bank.

The lower bankruptcy court held that this draw should be applied toward the landlord's capped claim and the appellate court upheld this decision. The appellate court reasoned that the intent behind § 502(b)(6) is to "compensate the landlord for his loss while not permitting a claim so large as to prevent other general unsecured creditors from recovering a dividend of the estate". Therefore, it focused on the impact of the landlord's undiluted claim on the property of the bankruptcy estate.

Mayan posted a cash security deposit with the bank in an amount over $650,000 to secure the LC. The sublease required that the "Sublease Letter of Credit, or so much thereof as remains after the curing of any default...shall be returned to [Debtor] at the expiration of the term of this Sublease and surrender of the Premises by [Debtor]". Because the collateral posted would have returned to *Mayan* upon lease expiration absent any lease default, the court characterized these monies as property of the bankruptcy estate.

Furthermore, the court reasoned that the true nature of this arrangement was a normal security deposit between landlord and tenant, with the bank merely inserted between the parties. Because the cash was essentially used to pay the landlord, the court saw this arrangement as an attempt to circumvent the effects of § 502(b)(6) and not one where a true third party obligor bears substantial risk. The language of the sublease further supported the court's opinion as it characterized the LC as "security for the faithful performance by [Debtor] of all of [Debtor's] obligations under th[e] Sublease". Citing this language, the court likened this arrangement to a traditional security deposit rather than a LC.

LESSONS OF THE *MAYAN* CASE

First, *Mayan* appears not to wipe out the Independence Principle entirely, but to require actual independence in the transaction. Specifically, the court clarified that parties may not label a security deposit a "letter of credit" to avoid the provisions of the bankruptcy code. Therefore, rather than negating the Independence Principle altogether, the court emphasized the importance of the nature of the arrangement, over the mere title of the document.

While the long term effects of *Mayan* are yet to be determined, Landlords can minimize the risk of similar results by ensuring proper lease drafting and by imposing more stringent requirements on a tenant's LC. Lease language which clearly distinguishes the LC from a traditional security deposit is extremely important in light of the *Mayan* case. Language which characterizes the LC as a "Security Deposit" should be redrafted and a Landlord might consider creating a separate agreement altogether to deal with a LC. Such a separate agreement, apart from the Lease, would however have some negative implications for the Landlord in that evictions and terminations of the Tenant's possessory interests in the Premises can only be premised on breach of the contract providing possession (i.e. the Lease). In addition, Landlords should closely examine the language of the LC to ensure that it doesn't appear to be a security deposit in disguise. Finally, Landlords may want to consider requiring a third party guarantor, to ensure true independence from the tenant, in larger transactions. BW

"Best Efforts" Clauses

What Do They Mean?

BY CLIFFORD R. HORNER, ESQ. AND DOUGLAS K. POULIN, ESQ.

THE CONTRACTUAL TERM "BEST EFFORTS," or one of its variants, is often a source of dispute and confusion because its meaning is ambiguous and not generally understood. Although the term "best efforts" may seem innocuous, there is inherent danger in its use because no consistent meaning has been given to the phrase by the courts. Consequently, a "best efforts" requirement can lead to expensive and acrimonious litigation.

"Best Efforts" clauses are frequently used in licensing agreements, lease agreements, purchase and sale agreements, and real estate brokerage agreements. A real estate purchase agreement, for example, may contain a clause requiring the purchaser to use its "best efforts" to obtain the necessary debt financing. The same type of agreement may require "commercially reasonable efforts" or "reasonable best efforts" by a party to satisfy the conditions to closing. Some leases include the landlord's requirement to use its "best efforts" to re-lease the tenant's space upon the tenant's default and turnover of possession of the premises.

Even though the terms "best efforts," "commercially reasonable efforts," or "reasonable best efforts" are utilized frequently by contracting parties in almost all types of commercial agreements, they are not well-tested in the courts, and have been given no consistent meaning. Indeed while some general principles can be gleaned from case law interpretations, there is by no means any settled law as to precisely what these two words, "best efforts," really mean.

Moreover, there is no case that interprets "commercially reasonable efforts," or even "reasonable best efforts" as distinct, less stringent standards than "best efforts." The few cases that have analyzed a contracting party's behavior in light of a "reasonable best efforts" clause often simply ignore the word "reasonable" and interpret the provision as a "best efforts" standard, rather than some lesser, greater or other performance standard. While common sense would suggest that "commercially reasonable efforts," "reasonable best efforts," and "best efforts" would be construed as imposing three distinct and separate performance standards, there is no clear guidance as to how a court would interpret these terms, or whether these terms would be treated differently.

Over and above the generally implied obligation to act reasonably and in good faith under the applicable circumstances, one court has defined "best efforts" as "taking in good faith, all reasonable steps to achieve the objective, carrying the process to its logical conclusion and leaving no stone unturned." This includes "doing everything known to be usual, necessary, and proper for ensuring the success of the endeavor."

In a licensing setting, courts have placed a greater burden on licensees under a "best efforts" obligation to sell the product, giving rise to a near fiduciary level of obligation. For example, in *Van Valkenburgh, Nooger & Neville, Inc. v. Haden Publishing Co., Inc.*, 282 N.E.2d 142, a publisher was found to have breached the explicit contractual obligation to use its "best efforts" to promote the author's work. The breach occurred when the publisher undertook to produce and market a series of books that were, in fact, competing with the author's series, and whose royalty agreement was more advantageous to the publisher. As such, in some circumstances, a "best efforts" clause can be found to be violated by an agent's agreements with other vendors to market similar products to similar prospective clients. Real estate agents should be mindful of this prospect.

Another example of the burden placed on licensees saddled with a "best efforts" obligation is illustrated in *Bloor v. Falstaff Brewing Corp.*, 454 F.Supp. 258. A large beer brewer and distributor purchased the labels, trademarks, accounts receivable, and distribution systems from the plaintiff brewing company in return for the defendant's promise to make royalty payments to the plaintiff. The contract required that the defendant "use its best efforts to promote and maintain a high volume of sales" of the beer products. The court held that the licensee had breached the "best efforts" provision by essentially going 'dark,' having closed four of its six retail distribution centers, which accounted for a very large portion of the licensee's sales. As such, a "best efforts" clause can in some instances be interpreted as a continuous operations covenant. Lessees should beware.

One California case, involving the lease of a restaurant, found that the lessee did not use its "best efforts," as required by the lease, to obtain a liquor license. The lease stated "[t]enant agrees to use its best efforts to obtain all permits and licenses. If tenant is unable to obtain said permits and licenses within said 90 days, this Lease will automatically terminate." The tenant thereafter vacated the property, arguing that the lease was terminated due to the tenant's failure to obtain a liquor license within 90 days, despite using its "best efforts." The landlord sued for enforcement of the lease, including future rents owed under the lease. The trial court agreed with the tenant that the lease was cancelled, but the appellate court reversed, finding that the tenant had <u>not</u> used its "best efforts" to obtain a liquor license.

The facts giving rise to this holding are as follows: The effective date of the lease was September 1. Therefore, all permits and licenses had to be obtained by December 1. According to experts on both sides, "it took an average of 60 days to obtain a liquor license from the date the application was filed." However, the process could be expedited so as to require less time.

The tenant hired a liquor-license expert to oversee the liquor license application process and contacted that expert on September 1. The tenant, however, did not inform its expert of the ninety day deadline until October 21. By failing to inform its expert of the necessity of expediting the proceedings at the earliest possible date, the court held the tenant had failed to use its "best efforts" to acquire its liquor license. The court stated that the plain meaning of the term "best efforts" denotes "efforts more than usual or even merely reasonable." The duty of "best efforts has diligence as its essence and is more exacting than the usual contractual duty of good faith."

As shown in this case, two courts do not always even agree as to whether a party has used its "best efforts" to accomplish a required condition with the exact same set of facts. As such, parties should be extremely cautious before agreeing to be bound by a "best efforts" requirement.

RECOMMENDATIONS

Generally, a "best efforts" clause requires performance "over and above" the norm or "reasonable person" standard. As such, it is generally desirable to have "best efforts" clauses associated with the opposing party's performance and not your own.

To require a counterparty to produce a particular commercial result, you should first consider simply imposing a flat obligation to accomplish such result, rather than agree to a "best efforts" standard.

If no such agreement can be reached, a licensor or lessor would want a "best efforts" clause to be expressly included in a license or lease agreement, in order to place a greater performance burden upon the licensee or lessee. A "best efforts" obligation can place the licensee or lessee in a position such that the licensee or lessee must expend optimum efforts and utilize all available capabilities in order to satisfy the obligations.

The licensee or lessee would want to narrowly define the term "best efforts" in connection with the specific agreement. This would be accomplished, for example, by defining "best efforts" as achieving certain specific goals or sales levels, or by spending certain amounts on advertising, or by contacting a certain number of potential buyers, licensing or permitting agency personnel, etc. By defining the term "best efforts" themselves, through a list of specific goals or objectives, the parties thus avoid the vagaries of a third party's interpretation of the term "best efforts."

Use caution in employing a seemingly less onerous variation of "best efforts," like "reasonable best efforts," or "commercially reasonable efforts," though such clauses may be tempting as a compromise formulation. While these alternative standards may facially appear to create less stringent performance obligations than a "best efforts" undertaking, the absence of case law interpreting the distinctions of these differing terms makes it difficult to be sure that these lesser terms would be interpreted any differently than the "best efforts" term itself.

Courts frequently look outside the language of the contract, to 'extrinsic evidence,' to interpret the meaning of a "best efforts" clause in a particular context. Such sources of extrinsic evidence can include testimony from industry experts, and possibly even testimony about the promising party's behavior in similar transactions in the past. Unless the specific performance standards that comprise a party's "best efforts" are spelled out in the contract, most courts will attempt to imply a standard from surrounding circumstances to make the provision enforceable. In other cases, courts have used an industry standard to determine whether the term "best efforts" carries with it a particular set of obligations.

For a contracting party, it is a sub-optimal situation when a court must turn to extrinsic evidence to interpret the meaning of a contract. There will most assuredly be a higher cost of litigation, as well as less clarity, prospectively, about its anticipated result.

The best way to create more certainty as to how a "best efforts" clause would be interpreted by a court is for the parties to specify, to the greatest extent possible, what exactly they mean in the context of the agreement. Under that approach, the parties could explicitly state, for example, that best efforts "does not require a material expenditure of funds or the incurrence of a material liability on the part of the obligated party." This approach provides a clear checklist for each party to follow.

Thus, it may make sense to provide that a purchaser's obligation to use its "best efforts" to obtain financing for a transaction will be satisfied if the purchaser performs the following: 1) submits fully completed loan applications to at least three qualified lenders within 10 days of receipt of a fully executed agreement; 2) responds to all lender queries and provides all further required lender documents within 48 hours of any such request, etc. Whether these kinds of refinements are appropriate for individual transactions will depend on the circumstances of each deal, including the relative negotiating leverage and sophistication of the parties, and other tactical considerations.

CONCLUSION

In all, though it may be agreeable to be the recipient of a "best efforts" undertaking where the other party refuses to agree to a flat obligation, or where it is otherwise impractical to clarify the character of the other party's performance obligation with more precision, it is ill advised to be the party providing a "best efforts" obligation unless you are prepared to be held to a very high, and largely unknown, level of performance. This is particularly true given the dearth of case law interpreting "best efforts" or similar clauses in commercial real estate contexts, such as purchase, lease, and brokerage agreements, where these clauses are frequently used. BW

Understanding Indemnity Provisions

BY SCOTT W. SINGER, ESQ.

INDEMNITY PROVISIONS CONTAINED IN COMMERCIAL LEASES are confusing and are often times overlooked or not understood by the business people involved in transactions. Business people frequently believe that indemnity provisions are "for the lawyers to handle." While lawyers typically negotiate and draft indemnity agreements, business people are well served to understand the basic principals because indemnity provisions are one of the most important provisions of the lease with respect to shifting and allocating the risk of loss. This article will attempt to cover the basics of indemnity provisions in plain English, utilizing practical examples to illustrate the impact of drafting modifications to the indemnity provision.

As a starting point, the concept of indemnity is a provision whereby the parties agree to allocate certain risk not between themselves, but from third parties. Legal dictionaries define indemnity as "A duty to make good any loss, damage or other liability incurred by another." Further definitions provide "The right of an injured party to claim reimbursement for its loss, damage, or liability from a person who has such a duty." Lastly, indemnity is defined as "The reimbursement of another for a loss suffered because of a third party's act." In practical application, indemnity is the process by which one party who may have been sued, shifts the burden of such third party lawsuit to another party based upon the language of an indemnity provision. For purposes of simplicity the courts and California practitioners generally classify indemnity provisions into "Type I," "Type II," and "Type III" provisions.

TYPE I INDEMNITY

A Type I indemnity provision is the broadest and requires that the Indemnitor (the person obligated to indemnify) indemnify the Indemnitee (the person receiving the benefit of the indemnity) in all instances of personal injury or property damage, and regardless of whether the Indemnitee's negligence was also a cause of the injury to person or property. Therefore, the Indemnitee (typically the Landlord in a lease) is entitled to the benefits of the indemnity provision even if its own active or passive negligence contributed to the injury. Landlord's lease forms typically attempt to codify a Type I provision and require that the Tenant indemnify the Landlord without regard to the Landlord's active or passive negligence. Another way of saying the same thing, and what some commercial leases provide, is that the Tenant is to indemnify the Landlord unless the Landlord's sole negligence was the cause of the injury. If the Landlord's sole negligence caused an injury, it is hard to make any argument that the Landlord should receive the benefits of an indemnity provision from a Tenant.

A Sample of Type I Language:

Irrespective of the availability to Landlord of insurance coverage maintained by Landlord, Tenant agrees to indemnify, defend and hold harmless Landlord, its property management company, the holder of any mortgage and or deed of trust and any ground lessor under any ground lease, together with their respective agents, employees, contractors, officers, servants, directors, partners, investors, licensees, members and affiliates (collectively "Indemnitees") from and against any and all claims, liabilities, damages, losses, causes of action, costs and expenses, including without limitation penalties, fines and reasonable attorneys fees and costs (collectively "Claims"), incurred in connection with or arising from any cause whatsoever in, on or about the Premises, including without limiting the generality of the foregoing: (1) any default by Tenant in the observance or performance of any of the terms, covenants or conditions of this Lease on Tenant's part to be observed or performed; (2) the use or occupancy or manner of use or occupancy of the Premises by Tenant or any person or entity claiming through or under Tenant; (3) the condition of the Premises or any occurrence or happening on the Premises from any cause whatsoever; or (4) any acts, omissions or negligence of Tenant or any person or entity claiming through or under Tenant, or of the agents, contractors, employees, subtenants, licensees, invitees or visitors of Tenant or any such person or entity, in, on or about the Premises or the Building, either prior to the commencement of, during, or after the expiration of the Term, including without limitation any acts, omissions or negligence in the making or performing of any Alterations. The foregoing indemnity shall not apply in the instance Landlord's sole negligence is the cause of the Claim.

Type I Example:

Assume the following facts: The Premises suffer a roof leak of which the Landlord is unaware which occurs on a Sunday night. The roof leak affects a portion of a Tenant's premises in an office building. Assume that first thing Monday morning a visitor of the Tenant slips and falls as a direct result of water on the floor resulting from the roof leak. Assume the roof leak was undiscovered at the time, and obviously not reported to the Landlord. Assume that the Landlord had no reason to know of the potential roof leak (no prior roof leaks, no recent roof work done). For purposes of the examples in this article, assume the court would determine that the Landlord is, if at all negligent, only passively negligent for failure to discover the leak. Under a Type I indemnity provision, if the Landlord were not negligent at all, or the Landlord were found passively negligent (or even actively negligent), the Type I indemnity provision would protect the Landlord in the event the visitor sued and named the Landlord as a party to the lawsuit. The Landlord would expect to be indemnified, defended by counsel of its choice, and held harmless by the Tenant.

TYPE II INDEMNITY

Type II indemnity provisions are common and unfortunately much more difficult to classify and understand. A Type II provision requires the Indemnitor to indemnify the Indemnitee, even if the Indemnitee was negligent; however the indemnity only applies if the Indemnitee was only passively negligent, and not actively negligent. Said another way, a Type II provision will not provide the Indemnitee protection if the Indemnitee was actively negligent in causing the injury. The distinction between active and passive negligence is where the confusion lies. Extensive case law exists, and we cannot in the limited scope of this article address such various circumstances.

A Sample of Type II Language:

"Indemnitor will hold Indemnitee harmless from any cause whatsoever."

Type II Example:

Assume the same slip and fall facts as above. Again, assuming the Landlord would be found only passively negligent, then a Type II indemnity provision would again protect the Landlord from the third party liability. However, if the facts were changed a little bit, the Landlord might not be able to avail itself of the indemnity protections. Assume that the Tenant discovered the roof leak three days earlier and reported it to the Landlord. Assume the Landlord failed to timely respond and that the Tenant reported the leak again the day before the slip and fall. Here, the Landlord might be found "actively" negligent, and therefore, might not be entitled to be indemnified by the Tenant. However, keep in mind that many of the types of risks addressed by indemnity, and in this article, would likely be covered by the Landlord's commercial liability policy.

TYPE III INDEMNITY

Type III indemnity provisions provide the least protection to the Indemnitee. Such a provision provides that the Indemnitor is to indemnify the Indemnitee for the Indemnitee's liabilities caused by the Indemnitor, but not for the liabilities otherwise caused. Pursuant to this provision, if the Indemnitee is in any manner negligent, whether active or passive, its action for indemnity from the Indemnitor is barred. This Type III provision is typically not found in commercial leases. It does not represent an industry accepted risk tolerance, and is not frequently found in practice. This sort of language should be rejected by Landlords.

A Sample of Type III Language:

"Indemnitor will hold Indemnitee harmless from any liability caused by Indemnitor"

Type III Example:

Assuming the same facts as above, if the court finds that the Landlord is at all negligent in causing the slip and fall injury, whether actively or passively negligent, the Landlord would likely not be entitled to the benefits of the indemnity provision. Again, the Landlord's insurance might well protect this loss, and insurance coverages should be carefully scrutinized by both Landlord and Tenants in their lease negotiations.

While the Type I, Type II, and Type III distinctions have provided the courts with a set of criteria to categorize and apply indemnity provisions, this classification system is no longer entirely dispositive. In 1999, a California case held that the intent of the parties is the most important factor in analyzing indemnity provisions. Generally, the courts will look to the intent of the parties with respect to risk allocation, and attempt to categorize the indemnity provision into one of the three classifications above. This sort of hybrid analysis will generally be applied by the courts in interpreting indemnity provision.

Probably the most important aspect of reviewing indemnity provisions is to ensure that an unintended result does not occur. For example, in a Type I provision, the Landlord can act in an actively negligent manner, and yet, the Tenant still owes the Landlord an indemnity obligation. Tenants need to ensure that they understand this result. In our experience, in order to avoid an unintended result, we prefer to add language that contribution can apply to this scenario. Contribution is a legal term which means that each party contributes to the extent of their liability. We believe that a fair result is often reached when the parties participate to the extent of their fault. In a Type I scenario, even if the Landlord is actively negligent in causing the injury, the Tenant may have also been negligent in causing the injury. The proper and fair result is for the parties to bear their proportionate share of fault, and ultimately the liability to a third party.

Hopefully, the examples above provide some clarity to a very complicated subject. Both parties to a commercial lease must be certain that they understand the type of indemnity provision contained in the lease and the implications of any modifications to that indemnity provision. BW

Notices Of Commencement Date In Retail Leases

BY PHILIP H. STOERMER, ESQ. AND KIMBERLY A. KUBENA, ESQ.

A "NOTICE OF COMMENCEMENT DATE" IS A FORM, usually attached to a retail lease as an exhibit, which is executed and sent following lease execution. The Notice of Commencement Date (referred to in this Article as a "Commencement Notice") is the mechanism whereby Landlord and Tenant agree on terms about which they were not certain when the Lease was executed. Most often, a Commencement Notice is a one page letter addressed by Landlord to Tenant clarifying the following uncertainties:

- the date upon which the leased premises are delivered to the Tenant (called the "Delivery Date"). Usually, this is the date upon which Landlord has "substantially completed" its construction on the leased premises (such as the building of Tenant's vanilla shell);
- the date upon which the lease term commences (called the "Term Commencement Date"). A typical Term Commencement Date is the earlier of (i) sixty days after the Delivery Date (which gives Tenant time to commence and complete its own work on the premises, such as fixturing, furnishing and stocking), or (ii) the date Tenant opens its business from the premises; and
- the date upon which rent becomes due from Tenant (called the "Rent Commencement Date"). The Rent Commencement Date usually falls on the same day as the Term Commencement Date.

The *commencement of the term* of the lease is different than *the date upon which the lease itself takes effect*. The latter is typically defined as the "Effective Date" or "Execution Date", occurring on the date when the lease is fully executed. This distinction is important because, particularly in circumstances where the Tenant is going to build on the Premises before it starts paying rent, there are many lease provisions (most notably insurance and indemnity) that need to become effective and binding when the lease is signed, not on some yet to be determined date in the future.

At the time of lease execution, the parties can usually estimate, but are very rarely certain about, these three important dates. So they agree during lease negotiations to let the Commencement Notice clarify their uncertainty. The Commencement Notice may also include statements about dollar amounts of rent, to whom and where rent checks are payable, the square footage of the Premises, share of common area charges and other expenses, and other pertinent information. A well-drafted Commencement Notice will include a provision which makes the dates conclusive (i.e. "If you do not contest the dates set forth in the notice within five (5) days, the dates will become conclusive and binding without further action by Landlord or Tenant.").

Sending the Commencement Notice (as a Landlord) and receiving and/or objecting to the Commencement Notice (as a Tenant) are very important but sometimes forgotten steps in retail leasing. The Commencement Notice can be referred back to throughout the term of the lease to determine "triggering dates" such as the lease termination date or the last day tenant can exercise an option to renew.

Also, in the circumstance where every other mechanism fails or purportedly fails to clarify Term and Rent Commencement dates, a factually correct Commencement Notice may suffice as a "catch-all" solution for a Landlord. For example, a lease may include language such as: "The term of this Lease shall commence on the earliest of: (i) the date of delivery of the Premises to Tenant for occupancy; or (ii) the date the Tenant Improvements to the Premises would have been substantially complete were it not for Tenant Delays; or (iii) *the date as conclusively established by Landlord in a factually correct Notice of Commencement Date in the form of Exhibit E.*" As such, even if the occurrence of (i) and (ii), above, were disputed, Landlord may still conclusively establish the Term and Rent Commencement dates by sending to Tenant a factually correct Commencement Notice.

Additionally, a Commencement Notice can be a critical tool in resolving lease disputes. An example: A Landlord and

Tenant execute a lease on January 1 whereby the Landlord is to complete Landlord's work on the Premises by March 1; thereafter, the Tenant is to step in and perform its construction. The Landlord finishes constructing a vanilla shell for Tenant and delivers the Premises to the Tenant on March 1. The lease says that when the Premises are delivered, Tenant must start its construction. But Tenant does not begin its work, and on April 20 the Premises are dark and unfurnished.

Becoming concerned about opening delays, the Landlord looks to its lease to determine if the Tenant is in default and if so, what may be its remedies. The lease states that the Tenant will go into default if it fails to timely pay its rent. The question then arises for Landlord, "When exactly is rent due?" The lease states that rent becomes due on the Rent Commencement Date (defined in the lease as the earlier of (i) 60 days after the Delivery Date; or (ii) Tenant opening for business from the Premises). Since Landlord thinks that it "delivered" the Premises on March 1, it calculates that rent is due 60 days later, on April 30. Landlord calls Tenant on April 21 to remind Tenant that rent is soon due. Tenant, unable to borrow enough money to pay first month's rent, wants to delay the Rent Commencement Date. So Tenant responds to Landlord that rent is not due until (i) Tenant opens its business (which it has no intention to do anytime soon), or (ii) 60 days have passed since Landlord "delivers" the Premises. Tenant insists that the Landlord has not "delivered" the Premises until Landlord fixes a broken door handle in the Premises, or at least that "Delivery Date" is not clearly defined in the lease. Who wins?

Without a Commencement Notice, the Landlord and Tenant could spend months arguing about when the Premises were actually "delivered", when the rent becomes due, and when the term commences. But Landlord has been savvy - it sent the Commencement Notice by certified mail on March 2, setting forth the Delivery Date (March 1), the Term Commencement Date (April 30) and Rent Commencement Date (April 30). The Commencement Notice included language that unless Tenant objected by March 9, the dates were conclusive and the Tenant was bound. Tenant received the Commencement Notice but never objected. Tenant realizes that because it failed to object by March 9, the Delivery Date, Term Commencement Date and Rent Commencement Date are now, for all intents and purposes, set in stone. So Tenant hurries to finish its construction and begins operating business and paying rent to Landlord on April 30. Landlord wins.

In the race to retail lease execution, uncertainties about important lease dates sometimes remain. The uncertainties are predicated on the "build-to-suit" nature of retail leasing, and are largely unavoidable. However, Landlord/Tenant disputes regarding important lease dates are often avoidable if the lease includes and the parties properly utilize a Commencement Notice. BW

Choosing The Appropriate Form Of Entity In Which To Own Real Property

BY PHILIP H. STOERMER, ESQ. AND KEVIN M. CORBETT, ESQ.

OWNING COMMERCIAL REAL ESTATE presents obvious potential financial benefits, but also brings substantial risk. Often, developers, landlords, and other landowners seek our counsel regarding strategies to maximize the benefits while minimizing the risks. One of the primary planning tools in accomplishing this goal is choosing the proper form of entity in which to own the property. The choices are mercifully finite; however, each has advantages and disadvantages which need to be analyzed in light of the landowner's particular goals.

In California (and most other states), the alternative forms of entity include corporations, partnerships, limited liability companies and individual ownership (often referred to as sole proprietorship in the business context). Corporations are subdivided into two categories: C corporations and S corporations. Similarly, partnerships are subdivided into general partnerships and limited partnerships. In deciding which form of entity is appropriate, the considerations can generally be distilled down to three main categories: (i) minimizing the principals' exposure to liability; (ii) accommodating the desired management structure; and (iii) optimizing tax planning. Some of the advantages and disadvantages of each form of entity as it relates to these considerations are set forth below.

I. LIMITING EXPOSURE TO LIABILITY

As any landowner is well aware, owning and operating commercial real estate exposes the landowner to a myriad of potential liability. Thus a primary objective of entity choice is limiting, to the extent possible, such landowner's (including the passive investors') personal exposure. The different entity forms vary with respect to the level of protection provided.

(a) INDIVIDUAL OWNERSHIP

Individual ownership means owning the property in an individual's own name, as opposed to having it owned by an entity. This presumes that there are no other individuals that expect to maintain an ownership interest in the property. This form of ownership provides absolutely no protection for the individual's personal assets in the event liability arises as a result of ownership of the property. Instead, a claimant could sue the landowner individually, and the landowner's personal assets would be available to satisfy any judgment. Given the potential magnitude of liability which can be generated from a commercial project, notwithstanding the availability of insurance proceeds that may or may not be adequate or available, putting one's personal assets at risk could lead to personal financial ruin. For this reason alone, owning commercial real estate as an individual is almost never advisable.

(b) PARTNERSHIP

When two or more individuals or entities wish to own real property together, one means of doing so is to form a partnership. A partnership is defined as an association of two or more persons to carry on, as co-owners, a business for profit. Under California law, there are two forms of partnership which are available for the purpose of owning and operating commercial real estate: a general partnership and a limited partnership.

A general partnership is the easiest entity to form, as it does not require any filings with the State of California, nor is it necessary to have a written partnership agreement. In fact, it is so easy to form that many persons do so inadvertently. Simply by entering into business with another person without organizing the venture as a corporation, limited partnership, or limited liability company, the participants may have by default created a general partnership.

Despite the attractively minimal start-up costs, general partnerships are often not the entity of choice for landowners, as they fail to provide personal liability protections inherent in the other entity forms. All partners in a general partnership have unlimited liability for all of the debts, obligations, and

liabilities of the partnership. This means that, in addition to partnership assets, each general partner's personal assets are at risk in the event a claim is brought against the partnership, and in the event only one partner has deep pockets, he/she may be sued for the entire liability of the partnership, even if the other partners cannot contribute. For this reason, most landowners are careful to avoid organization, whether intentional or inadvertent, as a general partnership, unless each of the partners take the form of a corporation or other entity designed to protect the individuals.

Another form of partnership available under California law is a limited partnership (an "LP"). This form provides for two different classes of partners, limited and general. The general partner manages the activities of the LP, and the limited partners are passive investors. The formation requirements are a bit more elaborate, as an LP must file a Certificate of Limited Partnership with the State of California, thus an LP cannot be formed inadvertently. As with the general partnership, a limited partnership agreement need not be in writing, but it is always advisable to document the agreement so as to avoid costly disputes later.

While the general partner is fully at risk for the debts, obligations and liabilities of the limited partnership, just as it would be in a general partnership, the limited partners enjoy limited liability protection. The only assets of a limited partner which are subject to a claim brought against the partnership are those that are contributed to the partnership by the limited partner. This means that a limited partner is able to quantify his/her risk exposure up front by deciding how much he/she wishes to invest in the venture.

One method of protecting the general partner of an LP from unlimited liability is to have the general partner be a corporation or a limited liability company. As discussed below, each of those entity forms may provide its principals the same liability protection that is enjoyed by the limited partners of an LP if the capitalization is adequate and the legal formalities are otherwise satisfied. Thus, the personal assets of the individuals comprising the corporate general partner (i.e., the shareholders of the corporation or the members of the limited liability company) would be shielded from liability by virtue of the corporate status. This would, however, this would require the formation of two entities, thereby possibly doubling the initial start-up cost.

(c) CORPORATION

The corporation is the most familiar form of entity, as most businesses are organized as corporations. The principals of the corporation are the shareholders. Corporate formation is more cumbersome than partnership formation. A corporation organized under the laws of California must file Articles of Organization with the State of California, and this document is a bit more comprehensive than the initial filings required of LPs. In addition to the Articles of Incorporation, the corporation will need to appoint a Board of Directors and officers of the corporation (many of which will be the same people in a small, private company), adopt Bylaws, and hold an organizational meeting (which will be recorded in the corporate minutes).

Once the corporate entity is formed, the Board must decide whether the corporation should be treated for tax purposes as a C corporation or an S corporation. The default is a C corporation, while electing S corporation status will require additional filings with the state and federal taxing authorities. The primary difference between a C corporation and S corporation has to do with the way that the entities are taxed, which is discussed in Section III below. There is no difference in liability protections.

All shareholders of a corporation enjoy the same liability protection as limited partners of an LP. Only the assets of the corporation are available to satisfy the debts, obligations, and liabilities of the corporation, thus the shareholders' personal assets are protected. The limit of the individual shareholder's risk exposure should be limited to the total purchase price of his/her stock if, as noted above, the capitalization is adequate and the legal formalities satisfied.

(d) LIMITED LIABILITY COMPANY

A relatively new form of entity under California law is the limited liability company (an "LLC"). An LLC is essentially a hybrid of a partnership and a corporation, as it is structured, managed and (generally) taxed in a manner very similar to a partnership, but it provides the liability protections of a corporation. The formation of an LLC parallels that of a limited partnership in that it requires a simple initial filing (the Articles of Organization) with the State of California, and execution of an operating agreement (which is analogous to a partnership agreement). The operating agreement may be oral, but again, to opt for an oral operating agreement to avoid the cost of preparing a written agreement would be "penny wise and pound foolish."

The principals of an LLC are the "members," and they are analogous to the partners of a partnership or the shareholders of a corporation. As with the limited partners of an LP, the members of an LLC enjoy limited liability protection. A major difference between the LLC and the LP, though, is that there is no requirement for a general partner equivalent in an LLC, thus no individual member's personal assets are subject to the debts, obligations, and liabilities of the LLC. Only the LLC assets are available for judgment, thereby allowing all members to quantify their risk by determining just how much they wish to invest.

(e) NOBODY IS BULLETPROOF

Although one can limit his/her exposure to personal liability considerably by thoughtfully engaging in the analysis set forth above and choosing the appropriate entity form, there are still instances in which no form of entity will shield individual liability. That subject is vast and any meaningful analysis of it is beyond the scope of this article. The basic premises, however, are as follows.

- **(i)** The limited liability entity formed must truly be a separate entity in order for the liability protections to apply. If the court determines that such is not the case, it will "pierce the corporate veil" and extend liability for the entity's debts or obligations to the individual shareholders, members, or limited partners, as applicable. The two primary bases for piercing the corporate veil are (x) that the capitalization is inadequate or (y) that the legal formalities have not been observed.
- **(ii)** A person is always liable for his own tortious conduct. He may be entitled to indemnity from the entity, but that, too, is a discussion for another time.
- **(iii)** A person who has personally guaranteed a loan, lease, or other agreement for the benefit of an entity will be personally liable in accordance with the terms of such guarantee.

(iv) A member of an LLC may waive liability protections as to any or all of the LLC's debts, obligations or liabilities by incorporating such waiver into the Operating Agreement.

(v) Any person responsible for withholding payroll taxes that does not deposit such withholdings with the IRS will be personally liable. Such responsible persons could include the President of a corporation or the manager of an LLC, and any others who have control over the disposition of corporate funds.

II. MANAGEMENT STRUCTURE

Another major consideration in determining the appropriate form of entity is accommodating the desired management structure. The spectrum spans from the very democratic "rule by committee" to the more rigid hierarchical structure.

(a) INDIVIDUAL OWNERSHIP

Individual ownership, as one would expect, gives the individual who owns title to the property absolute control, as there is nobody else involved.

(b) PARTNERSHIP

General partnerships are managed and controlled by all of the general partners, unless otherwise stated in the partnership agreement. This provides maximum flexibility, since the partners are free to agree on any form of management which they deem desirable.

An LP management structure is more stringent than that of a general partnership. LPs are managed by one or more general partners. The limited partners are not permitted to participate in the management of the business, and if they do so they risk losing their limited liability status. Thus, the general partner of an LP has more autonomy and control than the general partners in a general partnership, as he/she does not have to work in conjunction with the other partners. In fact, an LP partnership agreement may even eliminate the right of the limited partners to remove the general partner, thus giving the general partner even more autonomy and control than corporate directors and officers.

(c) LLC

An LLC offers more flexibility in determining management structure than any other form of entity. An LLC may adopt a decentralized, democratic and informal management structure akin to that of a general partnership. Or the LLC may opt to centralize the management duties (similar to an LP) by electing to be managed by a manager, as opposed to the members. In the event an LLC adopts a manager-managed structure, the manager, not the members, has the authority to manage the company. However, the members may retain certain decision-making authority or veto powers for themselves in the operating agreement. Unlike an LP (which is managed by a partner), the manager need not be a member of the LLC. The management structure may even be modeled after the management structure of a corporation, complete with officers and managers that act as a board of directors.

(d) CORPORATION

In a corporation, management and ownership are generally separated. Shareholders elect a Board of Directors, which directors need not be shareholders of the corporation. The directors, in turn, appoint the officers. As a practical matter, in small or closely held private corporations, director and officer positions are often held by large or majority shareholders.

The Board of Directors is charged with the responsibility of supervising the management of the business affairs of the corporation. The Board determines corporate policy and must authorize any actions which are outside the ordinary course of business of the company, including the raising of capital or the purchase or sale of substantial assets. The officers manage the day-to-day affairs. Shareholders have no managerial authority regarding day-to-day business activities, but they may appoint and remove directors from the Board.

III. TAX CONSIDERATIONS

Tax planning is an important and convoluted endeavor which may have substantial ramifications on the financial success of any real estate venture. The discussion below is intended to cover the basic considerations when choosing a form of entity, and is not intended to be an exhaustive tax planning analysis.

(a) PASS-THROUGH ENTITIES

A pass-through entity is one in which is not subject to income tax itself, but instead the entity's income or losses are passed through and taxed to, or deducted by, the principals (i.e., the partner or the members, as applicable). Partnerships, LLCs (unless the LLC formally elects otherwise) and S corporations are pass-through entities.

The primary advantages of pass-through tax treatment are that (i) the entity income is only taxed at a single level, (ii) losses are deductible by the partners and (iii) with respect to partnerships and LLCs (but not S corporations), profits and losses may be specially allocated to the partners or members. These advantages may be particularly attractive for real estate ventures, as such ventures often wish to specially allocate profits and losses to specific partners or members based on the timing and/or subjective value of their contributions.

On the flip side, pass through treatment may be a disadvantage if the entity has no losses, or if it intends on reinvesting its profits as opposed to distributing them. If profits are reinvested, the result is that principals may be taxed on their share without receiving cash to pay such taxes. Also, each principal will pay taxes at its personal rate, which is likely higher than the corporate rate. In order to avoid causing partners to come out-of-pocket for such taxes, the entity will often distribute funds sufficient to cover each principal's tax burden, but in such event the amount of the differential between the principal's personal tax rate and the corporate tax rate is money that goes into the government's coffers rather than those of the entity or the principal. Reinvestment of profits is not common in real estate ventures. Thus these disadvantages are generally not of great concern.

(B) C CORPORATION TAXATION

A C corporation is not a pass-though entity, thus it pays income tax at the entity level. This leads to the commonly lamented issued of double taxation, as corporate profits are taxed as corporate income, and when those profits are ultimately distributed to the shareholders, those shareholders will pay personal income tax, as well. For business ventures, such as real estate, in which the company intends on distributing the profits to the investors as opposed to reinvesting them in corporate infrastructure or research and development, such double taxation is a substantial disadvantage.

In order for a corporation to avoid the default of being taxed as a C corporation, the corporation must formally elect S corporation status by filing IRS Form 2553 with the IRS (i) within 75 days of the date the corporation began conducting business, (ii) before the sixteenth day of the third month of the current taxable year, or (iii) at any time during the taxable year that precedes the taxable year for which the election is made. In order to maintain the S corporation status, the corporation must abide by several restrictions, the most relevant (to real estate ventures) of which include:

(i) The corporation must have 75 or fewer shareholders, and these shareholders must generally be individuals, not entities (such as LLCs, partnerships, or corporations),

(ii) Non-resident aliens may not be shareholders, thus preventing foreign investment; and

(iii) The corporation may have only one class of stock, thereby precluding the ability to specially allocate profits or preferences to certain investors.

These restrictions generally make S corporations unattractive alternatives for real estate ventures, despite the potential tax benefits.

(C) CALIFORNIA STATE TAX CONSIDERATIONS

California imposes a minimum franchise tax on all entities which provide limited liability protection for their owners, which, as discussed above, includes corporations (C and S types), LPs and LLCs. Only general partnerships and sole proprietors escape the minimum franchise tax. Essentially, it is a premium for the limited liability protection, which most business people decide is well worth the price.

In addition to the minimum franchise tax, C corporations will pay state corporate income tax at a rate of approximately 8.84%. S corporations, despite being pass-through entities which are not required to pay federal income tax, will be assessed a state tax in the amount of 1.5% of net income. Partnerships (both limited and general), true to their pass-through nature, pay no form of state income tax at the entity level.

LLCs, in addition to the minimum franchise tax and despite being pass-through entities, are assessed an annual fee based on their gross revenues. This fee, often referred to as the gross receipts fee, is charged as follows:

Total Income	Annual Fee
Less than $250,000	$0
$250,000 to less than $500,000	$900
$500,000 to less than $1,000,000	$2,500
$1,000,000 to less than $5,000,000	$6,000
$5,000,000 or more	$11,790

This gross receipts fee is a definite disadvantage as compared to other pass-through entities which are not assessed such a fee, and must be weighed in the balance against the superior liability protection and management flexibility.

Choosing the proper form of entity is both art and science. The landowner must carefully map out his/her business objectives, and then choose the form of entity which accommodates as many of those objectives as possible, without sacrificing too many others.

Prior to the creation of the LLC, the most popular entity choice in real estate ventures was the limited partnership. Landowners appreciated the combination of liability protection for passive investors, flexibility of management structure and pass-through tax treatment. However, since the advent of the LLC, that form of entity has become increasingly popular, and now seems to be the entity of choice. It provides the best of all worlds: limited liability protection for all principals, maximum flexibility in designing a management structure, and a choice between tax treatment as a C corporation or a pass-through tax treatment with the ability to specially allocate profits and losses. BW

AB 1268 Codifies Form-Based Zoning Regulations

BY KIMBERLY A. KUBENA, ESQ.

CITIES AND COUNTIES ARE REQUIRED TO ADOPT comprehensive, long term "general plans", which contain text and diagrams explaining community development policies. The "land use element" of a general plan shows the location and extent of proposed land uses (e.g., housing, open space and commercial). Cities and counties can adopt zoning ordinances that regulate the use of private property, and those regulations must be consistent with the respective community's general plan. Among other effects, zoning regulations usually protect single-family residential neighborhoods from intrusion by commercial and industrial uses. This "use-based" zoning scheme often has the effect of creating suburban enclaves, thereby promoting sprawl.

Assembly Bill 1268 (Wiggins), signed into law in July, codifies "form-based" zoning regulations. "Form-based" zoning regulations are, essentially, models or template ordinances that, unlike conventional zoning ordinances, are organized by building and spatial type, not use. AB 1268 authorizes the text and diagrams of general plans and zoning ordinances to express community intentions regarding urban design and form by differentiating districts, neighborhoods and corridors. The text and diagrams can provide for a mixture of land uses and housing types within each district, neighborhood and corridor, and can provide specific measures for regulating relationships between buildings, and between outdoor areas (such as streets) and buildings. AB 1268 thus signifies a possible departure from use-based zoning, as it promotes the design of more cohesive neighborhoods through form-based codes.

The City of Petaluma is one of the first jurisdictions to implement a form-based system, using it as part of its new downtown specific plan. Petaluma's implementation of form-based zoning codes is reported to have greatly increased the number of development applications submitted to and approved by the City. Palo Alto, Pleasant Hill, Sonoma and Hercules are either using or preparing to use form-based codes.

The significance of AB 1268 for developers is as follows. Form-based codes are reported to expedite project approval because they alert property owners, in advance of filing development applications, to the community's expectations regarding development. Project review undertaken in connection with form-based zoning regulations is said to go more smoothly, in particular by easing the public hearing process.

AB 1268, as enacted, appears at Government Code Section 65302.4. BW

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KEVIN M. CORBETT, joined Berding & Weil LLP in May, 2004. Kevin grew up in Southern California, completed his undergraduate education at the University of Pennsylvania in 1991, and graduated cum laude from Tulane University Law School in 1995. Prior to joining Berding & Weil, Kevin was a transactional associate at Reed Smith LLP, a full service international law firm. Kevin's practice focuses on commercial real estate and corporate law. He represents clients on a vast array of real estate matters, including real property acquisitions and dispositions, joint venture development agreements, commercial leasing including office, industrial and retail, and real estate secured finance. The primary focus Kevin's corporate practice includes representation of start-up and middle-market companies from formation through liquidity event, including entity formation, Buy-Sell Agreements, general corporate maintenance, venture financing, securities compliance, acquisitions and sales of businesses and product lines and general commercial transactions. Kevin resides in Danville with his wife, Julie, twin daughters Katie and Eily, and his dog Fletcher (the only other male in the house). When he is doting on his wife and kids or searching for his golf ball in various hazards or adjoining fairways, Kevin enjoys skiing, traveling and dining. BW

KIMBERLY A. KUBENA joined Berding & Weil LLP's Commercial Real Estate Group in July, 2004. After graduating from UC Berkeley, Boalt Hall School of Law in 2000, she worked as a transactional associate at the law firms of Cooper, White & Cooper LLP in Walnut Creek and Cox, Castle & Nicholson LLP in San Francisco. Kimberly has experience representing clients in connection with a wide range of real estate matters including commercial acquisitions and dispositions, retail leasing (from both the landlord and tenant perspectives), office leasing, brokerage and consulting agreements, real estate management and operation, and various aspects of retail development. During her past two years of practice, Kimberly has emphasized shopping center leasing and development. She also brings to Berding & Weil's Commercial Real Estate Group her expertise in representing developers in relation to land use matters, including compliance with CEQA and other planning, zoning and development laws, and her knowledge of general and specific plans, zoning compliance and redevelopment. Kimberly writes and lectures on commercial leasing to real estate trade groups, and is a co-author of the forthcoming California Continuing Education of the Bar (CEB) Retail Leasing Manual. A Walnut Creek native, Kimberly returned to Walnut Creek in 2004, where she now resides with her husband, Keith. BW

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