

COMMERCIAL REAL ESTATE ROUNDTABLE



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As the Orange County commercial real estate market continues to regroup in the wake of the recession, there are still significant unanswered questions and concerns. The Orange County Business Journal has asked some of the community's top experts in the field to share their insights, concerns and predictions for the commercial real estate industry today. →

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Rutan & Tucker LLP

Rutan & Tucker LLP represents owners, developers, lenders, investors, tenants and builders in all aspects of commercial real estate. We regularly deal with all types of real estate including commercial, industrial, residential, multi-family, office, hospitality, retail, mixed-use and cellular. Our attorneys represent clients in a wide variety of real estate transactions and other areas. Real estate is in our roots at Rutan & Tucker LLP, and it has played a vital role in the growth of our firm. While the majority of our transactions involve California property, we have also helped a host of national and international clients in a broad range of industries attain their real estate goals. Whatever the opportunity or challenge, our depth of expertise and breadth of real estate experience ensure we see the whole picture. We take care of every detail to ensure a successful transaction—from assessing the pros and cons of each potential solution to drafting and negotiating all required documents.



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As several emerging markets have grown in recent years, the availability of global capital has steadily increased. This increased competition for transactions has helped drive increased values for real estate.

– Paul Louis, CPA
Audit Principal
Haskell & White LLP

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The Nonresidential Building Energy Use Disclosure Program (AB 1103), the law requiring sellers to disclose energy use to prospective buyers and lenders, has created some uncertainty in commercial transactions.

– Scott Cwiertny
Partner
Rutan & Tucker LLP

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► **What current industry regulations are having the greatest impact on your clients?**

Jane M. Samson, Newmeyer & Dillion LLP: Environmental regulations, absolutely, followed by environmental regulations. And then I'd have to say environmental regulations.

Ronald D. Stumpf, ELLS CPAs & Business Advisors: In order to secure financing more and more lenders are requiring the property to be held in a Single-Member LLC (SMLLC). Banks require this type of structure in order to limit liability with regard to each part of a project. For example, liability claims arising out of a parking garage held within a SMLLC are segregated from the office building that might be held by a separate SMLLC. A Single-Member LLC is a “disregarded entity” for federal tax purposes; however you still must file Form 568 in California and pay LLC fees.

In order to obtain asset protection, it is common to form a limited partnership with the individual as a 99% limited partner and a 1% S Corporation as the general partner. This gives the individual property owner added asset protection.

Scott Cwiertny, Rutan & Tucker LLP: Unfortunately, the Nonresidential Building Energy Use Disclosure Program (AB 1103), the law requiring sellers to disclose energy use to prospective buyers and lenders, has created some uncertainty in commercial transactions. For example, there are several broad exemptions to the disclosure requirement that will need to be further defined over time. Also, it is unclear whether a buyer can waive its rights to the law or what happens if a seller or borrower fails to make the disclosure. There is also a timing issue because the energy disclosure is required to be delivered to the buyer before the purchase contract is entered into. Lastly, lenders are supposed to be provided the disclosure by a borrower, but borrowers are generally unaware of this requirement. The implementation of the law has been delayed for buildings between 5,000-10,000 square feet due to website issues, resulting in some short term relief for smaller commercial transactions.

► **What are the potential challenges and pitfalls expected over the next 12 months?**

Rick Smetanka, Haskell & White LLP: Overall, the current economic environment feels positive; however, it is not difficult to spot signs of challenges that inevitably lie ahead. Whether it's in September or later this year, the Federal Reserve Bank is almost certain to raise its benchmark interest rate for the first time in almost a decade. Given the moderate and fragile economic recovery and the length of time since we've experienced higher interest rates, it is uncertain how our economy and CRE markets will react. Also, as the world continues to shrink and become more interdependent, our markets are more susceptible to geopolitical risks, such as the slowing Chinese economy or Greece's debt issues. I also believe that CRE businesses will be challenged by the rapid pace of change that tenants will demand in areas such as creative work environments, intelligent buildings and sustainable footprints.

Bruce Stuart, Stuart Kane LLP: There are significant concerns arising out of the potential rise in interest rates and their impact on both real estate financing and capitalization rates for properties. Further, uncertainty about the world economy and

its impact on the U.S. economy has created volatility in the stock market, which could easily impact real estate markets. A softening economy could lessen tenant demand, while at the same time volatility in the stock market may encourage investors to seek the predictability of income from rental real estate. By the time of this publication we will know the decision of the Federal Reserve with respect to interest rates and may start to see that potential impact.

Scott Cwiertny, Rutan & Tucker LLP: One potential challenge is implementation of Basel III regulations' “risk-weighting” assigned to commercial real estate loans, which affects a bank's capital requirements. Under these regulations, A&D and construction loans create “High Volatility Commercial Real Estate” exposure to banks and therefore carry with them greater capital reserve requirements. The regulations provide for certain exemptions of such loans from HVCRE classification (and the increased reserve requirements), such as one to four family residential properties, projects that would qualify as community redevelopment projects and projects meeting certain minimum loan-to-value, minimum contributed equity and limited distribution criteria. The impact these regulations may have on the commercial real estate industry may include (i) a shift away from A&D and construction loans to lending products with lower capital requirements to allow greater returns on capital, thereby reducing liquidity in the market, and (ii) higher lending costs for A&D and construction loans to retain desired returns.

► **How have changing international opportunities (investors/lending) affected commercial real estate transactions?**

Scott Cwiertny, Rutan & Tucker LLP: Similar to the residential real estate market, we are seeing a lot of Asian investors in the commercial real estate market and an uptick in “all cash” transactions. This has created a greater importance in verifying the availability of funds in the United States and in understanding the exact players on the other side of the transaction. For banks where the transaction is not “all cash”, this creates issues in complying with Know Your Customer Regulations and the Patriot Act. It also becomes important for the bank to understand the control and ownership structure of the borrowing entity. With the current volatility in the Chinese markets, it will be interesting to see what impact it has on the future of these types of transactions.

Paul Louis, Haskell & White LLP: In general, commercial real estate values are affected by occupancy, rental rates, net operating income, interest rates and cap rates. As several emerging markets have grown in recent years, the availability of global capital has steadily increased. This increased competition for transactions has helped drive increased values for real estate. With the increase in global opportunities, I think real estate managers, developers and operators will need to market their knowledge of local markets and tenants, adopt new investments vehicles that meet the global investor's needs and demonstrate expertise regarding international and local laws, governmental policies and taxes.

Global investors are seeking international real estate investment opportunities to diversify their

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Industry-approved forms may be an acceptable choice where the transaction and property are relatively straightforward and there are time and budgetary constraints – provided that the parties realize that they are trading precision and state-of-the-art for cost and time considerations.

– Jane M. Samson
Partner
Newmeyer & Dillion LLP

investment portfolio. These investors are not only seeking high-quality commercial real estate assets but are also considering opportunistic assets. The United States of America is once again considered by foreign investors as an attractive market for their investments.

► **What is the state of the commercial real estate lending environment?**

Bruce Stuart, Stuart Kane LLP: Currently there seems to be strong interest in insurance companies, banks and commercial mortgage-backed securities (CMBS) lenders providing permanent financing on seasoned, income-producing properties. Activity has increased with regard to development and construction loans; but only those owners or developers with projects that can be reasonably underwritten seem to have choices in the marketplace. However, if rates begin to rise significantly, that too could change quickly.

Scott Cwiertny, Rutan & Tucker LLP: In the residential construction arena, we are seeing plenty of A&D and construction loan activity. In connection with that, there is more financing available for those commercial centers which trail the development of the residential areas. While banks generally only originated deals with their “A” level clients during the recession, we are now seeing the availability of financing to a wider range of borrowers and more non-recourse lending. Importantly, we are also starting to see the return of commercial land loans and lending in markets that were previously considered weak.

► **Where do you see the CRE industry relative to the current overall economy?**

Rick Smetanka, Haskell & White LLP:

Generally speaking, most real estate sectors are trailing economic indicators - that is, as the overall economy goes, so goes CRE. Thus, I believe that there is much to learn about the current state of the CRE industry by studying the current macroeconomic environment. Nationally – as well as locally – I see many factors that are making significant contributions to solid economic growth, which is also driving strong CRE performance. The usual contributors, such as GDP growth, high consumer confidence and declining unemployment rates, are joining forces with eased lending standards (think higher loans, higher loan-to-value ratios and lower debt coverage ratios), strong international investment that once again views the U.S. as a “safe haven” and a new wave of innovation and technology. This formula yields strong CRE performance and that is exactly what we are seeing across our client base.

► **With transactions increasing, both in volume and the speed in which deals are done, what are the best ways to document commercial real estate transactions? Are industry-approved forms adequate?**

Jane M. Samson, Newmeyer & Dillion LLP: The best way is to adapt a contract previously negotiated and agreed upon between the same or affiliated parties; that’s not an option, of course, in most transactions. Industry-approved forms may be an acceptable choice where the transaction and property are relatively straightforward and there are time and budgetary constraints – provided that the parties realize that they are trading precision and state-of-the-art for cost and time considerations. Even then, however, I typically append to the form

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one of several addendums I've developed to clarify or supplement provisions in the industry-approved form. The more complex the deal terms or the property, however, the less suited standard form documents will be for the transaction.

► **Over the next five years, what are the most important commercial real estate trends that will impact Orange County (e.g. industry growth/fluctuations, lending practices, etc.)?**

Scott Cwiertny, Rutan & Tucker LLP: Within the last year or two, a number of crowd-funding companies have emerged in the Southern California area. While crowd-funding was initially limited to small transactions, there has been a clear increase in the number of large transactions involving crowd-funding. It is now becoming common place to find crowd-funding entities as investors in commercial real estate transactions in Orange County. However, it is difficult to predict crowd-funding's long-term impact in the Orange County area. With growth, comes regulation. Like most regulation, this may slow the trend of crowd-funding. Whether crowd-funding remains a viable option as an alternative to traditional types of equity or financing remains to be seen.

Rick Smetanka, Haskell & White LLP: In the years ahead, many economists forecast below-average U.S. labor force growth rates, which mean that companies will be battling even more intensely for talent in the future. As businesses compete for the best workers, the winning commercial real estate developers and managers will be those that are agile and innovative. Businesses will demand more from their real estate expenditures and expect those funds to help them achieve a

competitive advantage over their peers and competitors while also providing stimulating and fun work environments that will attract the best and brightest Millennials. I believe another trend that will challenge CRE will be a decline in space demand. A maturing Orange County will become even more competitive and many service industries will re-invent the office of the future to minimize space needs and reduce fixed costs. Other contributing factors that may push this trend include increased entrepreneurship and adoption of collaborative technologies.

► **What are the unique tax compliance issues that CRE firms are facing?**

Ronald D. Stumpf, ELLS CPAs & Business Advisors: Commercial real estate owners are looking for ways to defer gains on property sales. One common strategy to defer gains is to enter into a 1031 exchange, which allows the property owner to sell their real estate and reinvest the proceeds in new property. Sound advice on this matter can mitigate most 1031 exchange issues and provide a way for property owners to take advantage of this powerful tax savings option.

However, California has recently enacted legislation to close a tax loophole previously available to commercial real estate owners who exchanged a California property for a property in another state. The legislation now requires commercial real estate owners to report the exchange of California property for property in another state. This allows the FTB to track the new property until sold and requires the owners to pay California income tax on the taxable gain originally deferred.

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– Ronald D. Stumpf, CPA
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If an investor is looking to make a purchase, possibly as a result of an exchange, the challenge then is to find a suitable property that will be considered a positive addition to the portfolio. In each case, the investor has to consider market forces in general, those that apply specifically to the property and the particular challenges of that property.

– Bruce C. Stuart
Co-Founding Partner
Stuart Kane LLP

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► **What should a prospective buyer or seller of commercial property look for in a broker? What should a client expect from its broker, and what protections does the client have?**

Bruce Stuart, Stuart Kane LLP: In selecting a broker for purposes of acquisition or disposition of commercial property, experience in the marketplace and with a product type is important. If you are a buyer, you want an experienced broker who will have the opportunity to present not only properties that are then listed for sale, but who knows of properties that may be coming on the market. For a selling broker, experience in the marketplace means knowing comparables and the ability to assess demand to help a seller in establishing its expectations with regard to timing and price, and in terms of selecting the most qualified buyer (who may not necessarily be the highest bidder). As a seller you want to be certain your broker can assist in vetting these potential buyers so you have a qualified buyer who can and will close. Brokers generally should also be responsive and be creative problem solvers in order to quickly deal with events and circumstances that may occur, such as an unexpected physical condition, title issue or problem tenant(s).

► **In your experience, where, along the typical progression of a commercial real estate transaction, are the primary areas where problems most commonly arise?**

Jane M. Samson, Newmeyer & Dillion LLP: Problems often arise during the diligence process. If something material and unanticipated pops up through the buyer/tenant's investigations or through late or inadequate disclosure by the seller/landlord, then the timeline of the transaction likely will be impacted as the parties try to come to grips with the new information. The buyer/tenant may need to re-negotiate deal terms if the discovery changes the assumptions under which they entered into and underwrote the transaction. If a transaction involves financing, issues often arise in obtaining and then satisfying lender requirements within the parties' desired time frame. Lastly, "must have" contract provisions that vary from the norm and/or current market conditions can complicate negotiations on the documents.

Bruce Stuart, Stuart Kane LLP: In my experience in real estate transactions, whether a purchase, sale or lease, problems often arise in the transition from a letter of intent or term sheet to the actual documentation. These can be issues that were not fully addressed in the term sheet or ones that need to be re-examined given additional information that has arisen between the time of the term sheet and actual documentation. Often problems emerge during due diligence or inspection when a title or physical issue is discovered that may not have been known or considered, or, if known, turns out to be more serious than originally anticipated. This can especially be true when trying to assess an environmental or significant physical problem. Issues can arise concerning problems with tenant(s), discovered either through an estoppel certificate or direct contact. Lastly, at the closing and/or delivery of the property in the case of a lease, problems occur in determining whether or not all of the conditions to closing or completion have been timely satisfied, such as completion of

construction (punch list items) or financing.

► **What issues with the IRS have your commercial real estate clients recently encountered?**

Ronald D. Stumpf, ELLS CPAs & Business Advisors: Clients who invest or develop commercial real estate often assume that they qualify as a "Real Estate Professional" as defined by the IRS. However, the IRS has very specific rules that must be followed in order to qualify as a "Real Estate Professional". The key factor to obtain this status is maintaining a contemporaneous business log. IRS regulations under §1.469-5T(f)(4) prescribe the information taxpayers should record in a log including the date, description of service performed, and hours worked. The IRS will also request corroborating evidence such as calendars, appointment books or other supporting documentation. If you do not maintain a log, the IRS can disallow the "Real Estate Professional" status.

► **What concerns do you see that commercial real estate investors are having as they consider either purchases or changes in their portfolio?**

Bruce Stuart, Stuart Kane LLP: Most real estate investors continually look at their portfolio to determine whether or not a particular property should be retained or whether or not it is a candidate for disposition. This can be based on a combination of factors, including the general market conditions, the property location, potential for future appreciation, possible issues concerning tenant renewal, needed significant capital improvements or similar issues that may cause an investor to consider whether or not to hold onto a property and/or invest significant capital. [If an investor is looking to make a purchase, possibly as a result of an exchange, the challenge then is to find a suitable property that will be considered a positive addition to the portfolio. In each case, the investor has to consider market forces in general, those that apply specifically to the property and the particular challenges of that property.]

► **Before pursuing a land or property acquisition or joint venture, what due diligence do you recommend?**

Paul Louis, Haskell & White LLP: The due diligence process is a very critical step in creating a successful transaction and should be performed as early as reasonably possible. Depending on the type and complexity of a particular transaction, the due diligence process can be time-consuming and lengthy. There are number of procedures that investors should consider in their due diligence processes, and they are all important. In my experience, there are a few procedures that are critical. For example, location and logistics are vitally important for each type of real estate. I've also experienced investors that are solely concerned about the current economics of the transaction without focusing on the future marketing or operating challenges the project might have. For debt-financed transactions, investors should carefully review the lender's term sheet and covenants such as liquidity, debt service ratios and/or guarantees. Lastly, investors should inspect the physical property and engage experts to review complex areas, such as engineering, code compliance and environmental reviews.



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