



STRAIGHT TALK™

Perspectives on Real Estate Law

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Subleases: They're not as simple as they seem

With many commercial tenants experiencing financial difficulties, you may see an increasing number of requests for consent to subleasing arrangements. Keep in mind that subleases and “lease assignments” are separate and distinct legal concepts with very different legal relationships. A lease assignment involves the transfer of the remaining totality of the lease, whereas a sublease is for a lesser interest — for example, less than the total square footage or less than the remaining lease term.

Rather than simply signing the consent form submitted by a tenant, you should use the document to properly define the relationships between the parties and the obligations and rights of each party. If you don't, you could be saddled with unexpected liability, property management problems and difficulty financing or selling the property.

Scope of the consent

Work with your attorney to first make sure the form clearly states that your consent applies only to the act of subleasing, not to any of the specific terms and provisions in the sublease. This ensures you won't be bound by those terms. Also, remember that state law governs lease arrangements, so individual state statutes will

impact legal relationships, including rights of eviction and foreclosure. Before consenting to a sublease, make sure your mortgage agreements permit such action.

Further, the form should specify that your consent applies only to the *immediate* subleasing situation; any additional subleasing by your tenant or a subtenant will require separate consent. And the form should establish that your consent to the subleasing doesn't modify, waive or otherwise affect the terms of the original lease.

Relationships between the parties

The consent form should leave no question about the relationships between the three parties. It should state that the sublease is subject to all the terms of the original lease, and that if the subtenant violates those terms it's the *sublandlord* (that is, the original tenant) who will be in default.

Similarly, the form should provide the subtenant no recourse against you if you fail to perform your obligations under the original lease (although public policy may not make such language fully enforceable, at least for intentional defaults) — the subtenant should be able to proceed only against its sublandlord. It should make clear that the sublandlord also must be fully responsible for all rent payments and the performance of its obligations under the original lease.

The consent form should provide that, if the sublandlord goes into default and the cure-and-notice period expires, the subtenant, upon receipt of written notice, will pay rent directly to you. It also should note that your acceptance of such rent doesn't release the original tenant from its obligations, nor does it represent an acceptance of the subtenant as a direct tenant.

In addition, the consent form should give you the right to succeed the sublandlord's rights, title and interest in the sublease if you terminate the original lease before the sublease expires. The termination then converts the sublease to a *direct* lease between you and the subtenant. You also



should use the consent form to disclaim any liability for the sublandlord's acts or omissions.

Finally, the form should require the subtenant to maintain the same liability insurance that you required the sublandlord/tenant to procure under the original lease. As with the sublandlord, the policy should name you as an additional insured.

More than meets the eye

Overlooking the issues above could significantly alter the legal relationships between you, the tenant and the subtenant, and even reduce the overall value of your property. In fact, you may want to address these and other critical issues in the original lease, rather than the consent form. ❖

Developments in CERCLA

Why legal title to land isn't necessarily enough for cleanup liability

It may seem like the EPA always comes out on top in environmental liability cases, but the Seventh Circuit U.S. Court of Appeals recently declined to rule for the agency in an action to recover response costs from a potentially responsible party. In *U.S. v. Capital Tax Corp.*, the court held that, depending on the relevant state law, a party may not be liable for cleanup even though it held legal title on the contaminated property.

Laying the groundwork

Capital Tax engages in the business of buying and selling the tax deeds on distressed properties. It bids on delinquent taxes at tax scavenger sales, where the winning bid receives the tax certificate for the property. If the original property owner fails to pay the taxes within a statutory time period, the winning bidder can petition for the tax deed to the property. Tax certificates don't pass title on the property but are similar to an option to later obtain title.

Capital Tax successfully bid on the tax certificates for a derelict paint factory in Chicago. It then entered an oral agreement to obtain the tax deeds and convey them to Mervyn Dukatt for about \$25,000. Dukatt gave Capital Tax a \$15,000 check and, pursuant to the alleged contract, Capital Tax obtained the tax deeds and delivered possession of the property to Dukatt.



Capital Tax retained legal title as security for the remainder of the purchase price, but Dukatt never made another payment. After obtaining an order of eviction to secure possession of the property from the previous owner, Capital Tax had very little to do with the property. Dukatt, however, frequently visited the site and hired workers who cut up and removed paint machines, replaced a garage door and knocked down two walls.

Subsequent inspections by local environmental authorities and the EPA uncovered thousands of containers, many of which were rusty and leaking hazardous waste. After the EPA performed the cleanup, it brought suit against Capital Tax to recover the response costs and civil penalties. The district court ruled in favor of the EPA.

Applicable federal law

Under Section 107(a) of the Comprehensive Environmental Response, Compensation, and Liability

Act (CERCLA), the EPA can recover damages for environmental cleanup from potentially responsible parties (PRPs). PRPs include the “owner and operator of ... a facility.” CERCLA defines “owner” as “any person owning” a facility.

The EPA asserted that Capital Tax was the owner of the property because it held legal title to five of the seven parcels at the site. Capital Tax countered that it held legal title only as security for the balance of the purchase price — in other words, that equitable ownership of the property passed from Capital Tax to Dukatt when their contract was executed. The court referred to this as “a classic ‘equitable conversion’ argument.”

In most jurisdictions, on entering a contract for the purchase of land, the buyer is the owner in equity of the property, and the seller holds legal title as security for payment of the purchase price. The court cited two federal courts of appeals that have held that public or quasi-public companies that hold legal title to property to secure recoupment of development costs aren’t “owners” under CERCLA. It also noted that a number of district courts have applied the doctrine of equitable conversion in CERCLA cases.

Under CERCLA, the EPA can recover damages for environmental cleanup from potentially responsible parties (PRPs).

The role of state property law

In *Capital Tax*, the court was left to decide whether to fashion its own federal rule for applying the doctrine of equitable conversion or to look to applicable Illinois law. It concluded that it need merely to look to state law for guidance, primarily because property relations have historically been governed by state law. Further, the various state laws generally agree on the operation of the doctrine.

In Illinois, the party invoking the doctrine must show that a valid and enforceable contract exists. The

Another defense for PRPs

The Court of Appeals in *Capital Tax* (see main article) observed in a footnote that Capital Tax has a potentially legitimate argument that it qualifies for the “security interest exclusion” to ownership liability — even if it didn’t have a valid and enforceable contract that transferred ownership to Dukatt under Illinois law.

Section 101(20)(A) of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) excludes from the definition of an “owner or operator” any “person, who, without participating in the management of a ... facility, holds indicia of ownership primarily to protect his security interest” in the facility. “Security interest” includes the right to secure the repayment of money under a mortgage, deed of trust, assignment, security agreement or lease. A lender, for example, wouldn’t be liable solely because a mortgage is secured by an interest in contaminated property, provided the lender doesn’t participate in management. And merely having the capacity to influence, or the unexercised right to control, the facility doesn’t constitute “participating in management.”

According to the *Capital Tax* court, “The exclusion explicitly recognizes that a person can hold ‘indicia of ownership,’ such as legal title, and yet not be the owner under CERCLA.” It’s up to a court to determine if the PRP holds such indicia.

Illinois statute of frauds requires that a valid contract for the sale of land be in writing, but state courts have routinely recognized exceptions, including for past performance. A contract for the sale of land need not be in writing if the buyer makes whole or partial payment of the purchase price, takes possession and makes substantial and lasting improvements.

Stay tuned

The Court of Appeals sent the case back to the district court to determine if Capital Tax had a valid and enforceable contract under Illinois law. If Capital Tax didn’t have such a contract, it could be liable as an owner for cleanup costs and could also owe \$230,250 in civil penalties. But if it did have a valid contract, it might not be responsible for any of the EPA’s response costs — an amount nearing \$2.7 million. ❖

Keeping a lid on exit costs

Borrowers interested in refinancing or selling properties subject to commercial mortgage-backed securities (CMBS) loans that result in prepayment of the loans generally have two options depending on the language of the loan agreement: 1) yield maintenance, or 2) substitution of collateral through defeasance.

Both methods release the borrower from its loan obligations, but one may prove more cost-effective than the other, depending on the circumstances.

Yield maintenance

With yield maintenance, the borrower prepays the loan's unpaid principal balance, including a prepayment penalty. If interest rates have fallen, the penalty allows the lender and bond holders to attempt to recover the same yield it would have received if the borrower had made all payments on the loan through maturity.

The penalty is typically based on the replacement rate, which often is the rate on the U.S. Treasury that has the closest maturity date to the loan. The difference between the loan's rate and the Treasury's rate represents the lender's loss if prepayment had been allowed without any penalty. The higher the loan rate and the lower the current Treasury rate, the greater the penalty.

Yield maintenance provisions usually incorporate a minimum penalty of 1% to 3% of the outstanding balance. Thus, even in an environment where the Treasury rate is greater than the original loan rate, the borrower will incur a penalty.

Substitution of collateral

Defeasance began in the municipal market and was adapted for the commercial real estate market in the mid-1990s. With defeasance, the borrower substitutes collateral, generally a portfolio of securities, for the real property that originally secured the loan. The loan is

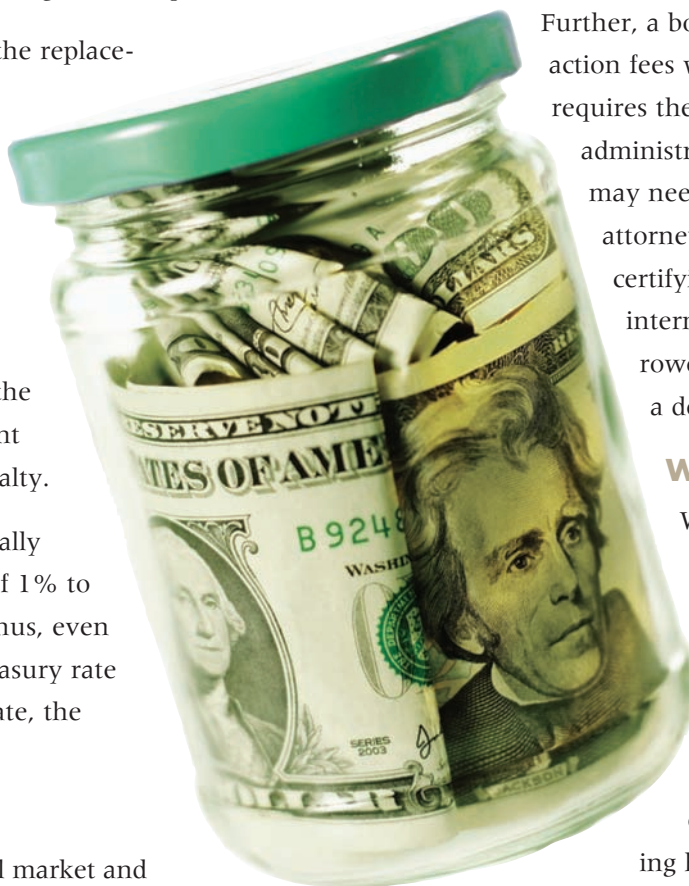
assumed by a successor borrower, and future payments come from the cash flows generated by the securities through coupon payments and maturing securities. The original borrower is released from all financial obligations, which are assumed by the successor borrower.

Although defeasance imposes no formal penalty *per se*, the borrower may incur a quasi-penalty based on the cost to purchase a portfolio that matches the loan's debt service schedule. If the Treasury rate on the portfolio is more than the loan's interest rate (meaning the average yield of the portfolio exceeds the amount of the loan payments), it will cost less to purchase the portfolio to cover the outstanding balance on the loan. Conversely, if the interest rate on the loan exceeds the Treasury rate, the cost of the portfolio will be more than the outstanding balance.

Further, a borrower will incur transaction fees with defeasance, which requires the involvement of several administrative parties. The borrower may need to pay the fees of its attorney, the lender's attorney, a certifying accountant, a securities intermediary, the successor borrower and its attorney, and a defeasance consultant.

Which is better?

With many loans today, defeasance is the only option for exiting a CMBS loan. If both defeasance and yield maintenance are available, defeasance may be the less costly option in a market boasting high Treasury rates because it carries no minimum formal penalty and a quasi-penalty is unlikely. In a market with low Treasury rates, yield maintenance may be the more



attractive option — the cost of a portfolio for defeasance would probably exceed the loan’s outstanding balance.

Loan language

The ultimate cost to exit a CMBS loan is driven by the current interest rates and the loan documents — and the borrower can exert control only over the latter. Provisions regarding yield maintenance should include a straightforward formula for calculating the penalty.

With defeasance, a borrower should retain the right to purchase the portfolio and include governmental agency

securities in it. Agency securities often pay a higher yield than Treasury securities, resulting in reduced costs.

Think long-term

Borrowers need to think about exit scenarios from their CMBS loans from the outset. Loan documents can rarely be renegotiated, so it’s critical to secure favorable exit provisions should you later wish to sell or refinance your property. ❖

Helpful tool presents legal risks to the unwary

Building Information Modeling (BIM) has become an increasingly common technological tool in design, construction and building management. BIM is essentially a database of electronic information that multiple design and engineering participants can contribute to and access at any time.

The technology allows users to view a 3-D model created by data related to a building’s elements and their relationships to each other. In addition to facilitating up-to-date analysis of project design, scope, schedule, costs and other issues, the models produce space calculations, energy efficiency analyses, structural details and design documents. Although it offers benefits to owners, designers and contractors, BIM also presents some legal risks.

Liability and intellectual property issues

With multiple contributors, the lines separating the obligations and liabilities of each can become blurred, making it difficult to allocate risk. Should it be allocated equally among the users, allocated based on compensation or allocated on some other basis? If a design or engineering claim arises, the claimant may pursue every contributor to increase the likelihood of actual recovery.

Intellectual property issues can come up as well. If multiple parties contribute to a design, who owns the copyright? Can a contributor use design elements in subsequent projects without risking infringement? Can elements of the design even be unbundled? And how will the parties ensure the confidentiality of proprietary information when necessary?

Proceed with caution

These are relatively new issues that, ideally, parties need to address in their contracts. Standard form contracts, however, are unlikely to address these developments adequately.

Additionally, courts haven’t yet been confronted by many of the related legal complications, so not much case law is available to provide guidance. Nevertheless, all involved should try to address potential legal issues related to BIM early on in the contract negotiations to preempt later disputes.



New lead paint rule colors renovation projects

The EPA's relatively new rule requiring the use of lead-safe practices is designed to prevent people from contracting lead poisoning during renovation, repair and painting projects. Although the rule was first enacted in spring 2008, the agency is phasing in the requirements over two years, with the major requirements taking effect in April 2010.

Anyone engaged in construction, contracting, leasing and property management may fall under the rule's requirements. Let's look at what the rule entails.

Contractor certification required

Beginning April 22, 2010, contractors performing projects that disturb lead-based paints in homes, child-occupied facilities and schools built before 1978 must be EPA-certified and follow specific work practices to prevent lead contamination. A "child-occupied facility" encompasses any building, or a part of a building, that's visited regularly by the same child, under six years of age, on at least two different days within any week. Each visit must last at least three hours, with the combined weekly visits lasting at least six hours, and the combined annual visits lasting at least 60 hours.

The EPA rule doesn't apply in cases when a certified inspector or renovator determines that a renovation won't involve lead-based paint.

The rule doesn't apply to minor maintenance or repair activities where less than six square feet of lead-based paint is disturbed in a room or where less than 20 square feet of lead-based paint is disturbed on the exterior. The rule also doesn't apply in cases when a certified inspector or renovator determines that a renovation won't involve lead-based paint.

Required and prohibited practices

Specific work practices the EPA requires renovators to follow when performing projects affected by the new rules include:

- Posting signs to keep nonworkers outside the work area,
- Containing waste and cleaning the work area after the project is complete, and
- Performing certain daily tasks, such as using high-efficiency particulate air (HEPA) vacuums in the work area.

Additionally, the EPA specifically prohibits certain practices when working with lead-based paint — even during minor activities. They include:

- Open flame burning or torching,
- Sanding, grinding, planing, needle gunning or blasting with power tools unless equipped with a shroud and HEPA vacuum attachment, and
- Using a heat gun at temperatures greater than 1,100 degrees Fahrenheit.

As the EPA has noted, the property owner has ultimate responsibility for the safety of both its tenants and children in its care. Owners must properly prepare for covered projects, see that nonworkers are kept out of the work area and ensure that their contractors use lead-safe work practices.

The ultimate responsibility

Going forward, property owners should leverage their contracts to specify contractors' responsibilities under the rule and establish appropriate remedies if the rule is violated. Contact your attorney for more information on the new rule. ❖



TIPS ON NEGOTIATING AND DRAFTING CONTRACTS

At the epicenter of most disputes is that document where risk can and should be effectively managed; viz the construction contract. Far too frequently, insufficient attention is devoted to this “first line of defense” in risk management.

A. Drafting Tips

1. Know With Whom You Are Dealing

As important as it is to have a carefully drafted contract, it is equally, if not more, important to know with whom you are contracting. If you are the construction contractor, for example, carefully check out the owner. Has he had previous experience in project construction? If so, has he had disputes with contractors in the past? Also, make sure that the owner has the financial resources to pay for the work. In that regard, it is a good rule of thumb to make sure the owner has the ability to pay for the contract sum plus at least an additional 10% for additive change orders and extra work, exclusive of design and consulting costs and fees.

If you are the owner, check out the contractor’s past work. Has he ever failed to complete a job? Is he litigious? Is he financially stable?

On private construction projects – where performance and payment bonds are not statutorily proscribed – careful consideration should be given to requiring the contractor to furnish bonds. Generally, bond premiums range between 1% to 3% of the total contract price, although, on very large projects, the premium may be less than 1%. Construction is a risky business. Dun & Bradstreet reports that approximately 10,000 contractors fail on an annual basis and approximately 40% of those contractor failures involve contractors in business ten years or longer.

As a potential cost saving measure, consider requiring bonds from the general contractor’s major subcontractors. And, as a way of increasing your “comfort level” request a letter from the contractor’s bonding agent as to the contractor’s bonding program and what his current bonding capacity is.

2. Always Attempt to Create the First Draft of the Contract

Although more of a drafting technique than a negotiating technique, you should always attempt to create the first draft of the contract. While this may require you to spend additional costs and fees, forcing the other party to negotiate off your document may actually save you money in the long run. It also gives you the ability to choose a contract form that best suits your needs and objectives. Writing the first draft also allows you to define the issues to be addressed and to set the tone of contract negotiations.

3. Approach Contract Negotiations With a Reasonable Degree of Skepticism

In the beginning, no one expects problems to arise and even if they do, they will be amicably resolved. As you approach contract negotiations, try to anticipate where

there could be major areas of dispute and craft an appropriate disputes resolution clause to deal with those disputes.

Also, avoid including language in the contract that the parties will agree to resolve unresolved matters in the future or will agree to “negotiate a resolution in the future in good faith.” Such language creates very little in the way of a substantive commitment. It could lead to litigation over whether a party has exercised “good faith” in attempting to resolve a dispute.

4. Do Not Overly Rely on Standard Form Contracts

Over the years, a number of professional societies and trade groups have developed standard form contracts for construction projects, contracts with architects, real estate purchase and sale agreements and leases.

Experience has shown that parties are more comfortable utilizing standard form contract documents. Because of that, there may be unjustified reliance upon the standard form language simply because it is purportedly standard form language. Careful consideration should be given to the type of standard form contract to be used and even more attention should be given to its modification. However, not every standard form contract can be adaptable to every project. Rather than heavily modifying a standard form contract, it may be more prudent to create your own standard form.

B. Negotiation Tips

The first step in the negotiation process is to understand exactly what the client’s objectives are and the type of project being constructed or designed. This will better equip the drafter to select and/or adapt one of the many standard form contracts in existence. Please note once again that not every standard form contract can be adaptable to every project.

As with any contract, each contract provision has its own ranking in terms of importance. Thus, before the careful drafter begins his negotiations he should always have a clear understanding with the client as to which clauses must be included and those which can be included or excluded without adversely affecting the overall meaning and intent of the document. Clauses with little or no importance can often be used as “negotiating” chips to be bargained away in exchange for more acceptable language in areas within the contract with a higher importance ranking.

Finally, although more of a drafting technique than a negotiating technique, the careful drafter should always attempt to create the first draft of the contract. While this may require the client to pay slightly more in attorney’s fees, forcing the other party to negotiate off this document may actually save the client money in the long run. It also gives the drafter the ability to choose a contract form that he feels best suits his client’s needs and objectives.



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