CONNECTING REAL ESTATE IN THE WEST
WESTERN REAL ESTATE BUSINESS

LEGAL Q&A

Some of the West's top legal experts tackle five questions aimed at providing both advice and warnings to those navigating today's commercial market.

Andrew Kirsh
Partner
Raines Feldman LLP
in Los Angeles

How has your field changed over the past two years as we've emerged from the Great Recession?

It's night and day. In 2009 and 2010, I felt like an emergency room doctor, in that my work was mainly triage. I was consumed with workouts, loan modifications and business "divorces." It was no longer about deal creation. Instead, it was predominately about minimizing losses. Deal flow started to return in 2011 and has certainly reaching its full effect in 2012. This all began with note purchase transactions. Eventually, asset purchases also came back. Though multifamily kicked off this trend, I'm now seeing lots of activity across all asset classes. There's an abundance of capital chasing a seemingly small number of deals. Just two years ago it seemed like we were at the bottom of the abyss, now deal flow is so active it's like drinking from a fire hose.

What are the most pressing legal issues affecting the commercial real estate market?

Transparency is definitely one of the most pressing issues. Before closing a transaction, capital providers on both the equity and debt sides want as much information about their sponsors/borrowers and on the underlying property as possible. After closing, my clients want to stay intimately involved with the transaction and keep their sponsors on a short leash by imposing very strict monetary covenants that require the sponsors to stay within the projected deal budget. This also extends to non-monetary covenants. In fact, not only did we recently negotiate for monthly meetings between the capital and the sponsor, but we mandated that the sponsor's property-level employees also had to be in attendance. Capital providers do not want to be surprised and, therefore, want to have the same information as their sponsors.

What current issues seem to be affecting the success of commercial developments or properties?

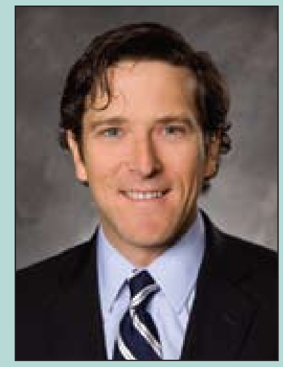
Despite what our local politicians say they want to achieve, a developer still has to go through many layers of bureaucracy to get a development deal fully entitled. Moreover, given the recent cutbacks in the statewide judicial system, if any of my clients need to get court approval on a deal or a project, it now takes longer to get that accomplished. As a result, developers need to budget a longer schedule if they need the assistance of the government or judicial system.

What advice would you offer someone who was entering the commercial market for the first time?

Have patience. Many of my clients get frustrated at the lack of deals that make sense. There are many groups with a cost of capital that is rather inexpensive, such as REITs or certain pension funds. As such, they can over-spend on certain assets. Because of this, it can be strategic to find a niche area, or deals below a certain purchase price where there isn't as much competition. Finally, if you are just starting out, network like crazy. A lot of the good deals are off-market, so meet as many people in the industry as you can. That way, they'll think of you when a deal surfaces.

What do you think 2013 will bring?

I fear that we may be in a bubble and the market could overheat. With access to inexpensive debt reaching 2006 to 2007 levels in certain asset classes – especially multifamily – I wonder if we are all suffering from short-term memory loss. I ask people why we're not headed in the same direction as we were a few years ago….but no one seems to remember that far back.



J. Craig Cartwright
Partner
Snell & Wilmer L.L.P.
in Phoenix

How has your field changed over the past two years as we've emerged from the Great Recession?

The good news is that the overall level of commercial real estate work has been slowly increasing over the past couple of years, but given how badly the market was hammered by the Great Recession, in many respects there was nowhere to go but up. Activity is better now, but that is only when compared against the prior years' anemic levels. We are still not at a level of activity as an industry that one could reasonably consider to be healthy. The bulk of the work in the industry still appears to be loan workout/restructuring/foreclosure work, but the more traditional development work does exist and is always enjoyable when you get to work on it. The general consensus is that the average size of the development deals that do exist are smaller and less complex than they were during the mid-2000s. Bright spots in the industry from a development perspective continue to be healthcare and multifamily, but hopefully those do not become the next bubbles to pop.

What are the most pressing legal issues affecting the commercial real estate market?

The absence of available capital in the development sector continues to be a significant issue with respect to the expansion of the commercial real estate industry. Financing has become more prevalent and available with respect to institutional buyers like REITs acquiring established properties and concepts. This trend does appear to be improving overall, but capital availability is still a hindrance to full recovery of the industry. The influence of the federal and state governments on the industry continues to be significant as well. The uncertainty regarding the direction the policy-makers will go with respect to taxation of investment income, healthcare and other major issues certainly impacts the willingness of investors to get into the market. It seems the only certain thing about Washington at this point is gridlock, but whether it is the fiscal cliff, Obamacare, or the European and Asian economic issues, they are all factors with respect to the average consumer's ability to purchase and the average investor's willingness to invest.

Another issue facing the commercial real estate lawyer is the cost-cutting procedures employed by the modern client, which create a very challenging situation for the lawyer. It is difficult to provide the guidance and value clients are seeking when the lawyer is cut out of some aspects of a transaction or key discussions and decision-making. The attorney needs to continue to work to figure out a way to protect his or her clients, even when armed with less information and exposure to the transaction, and in the face of heightened risk of unforeseen or deeply embedded legal issues.

What current issues seem to be affecting the success of commercial developments or properties?

Across the board, it seems the local governments and municipalities are now willing to work with anybody with a viable plan and a good track record in order to stimulate investment and job creation in their communities. Local governments that were reviled for being anti-growth or difficult to work with have become quite a bit more open to projects. This is because the competition for them is so fierce, and the need to demonstrate something positive to their constituents is so pronounced. Therefore, at a local level, things are typically very positive, with the only caveat being that delays sometimes occur due to the extremely lean staffs the towns and cities now

Continued on page 20

J. Craig Cartwright, Snell & Wilmer L.L.P. continued

employ to handle planning and development. It is not typically due to a lack of desire or effort, but more a function of a lack of available manpower.

At the state level, however, it is a different story, at least in some states. My colleagues in Nevada believe that the draconian limitations on residential foreclosures, recently passed by the Nevada legislature, will merely prolong the pain and lengthen the time it will take for that market to sort itself out, which will continue to have a deleterious effect on the commercial market. On the positive side in that state, the legislature and government officials do appear to be open to advancing other measures that will help the industry, and some of the existing red tape may be reduced to encourage new development. In contrast to Nevada, the existing red tape in California does not appear to be going anywhere. In fact, recent developments with respect to redevelopment agencies have created a host of new issues for an already beleaguered industry to absorb. Commercial development in California will continue to be an expensive and slow proposition, which, at this point in the recovery, does not typically result in a completed project.

Arizona's state government has always been less restrictive than California – and that continues to be the case – but watchdog groups like the Goldwater Institute continue to loom over creative solutions for financing and governmental-industry partnerships, which once again has a negative impact on dealmaking.

Another less obvious outcome of the Great Recession was a massive consolidation of the title insurance industry, and a significant pull-back in the willingness of title insurers to offer key endorsements and coverages. For example, the creditors' rights endorsement no longer exists, and underwriting with respect to issuance of endorsements has become much more intense. These factors have forced purchasers and lenders to re-think what they will be able to achieve with respect to title policy coverage.

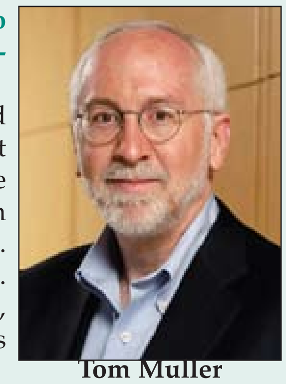
What advice would you offer someone who was entering the commercial market for the first time?

Be well-capitalized, be smart and be alert. There are deals to be had, but not every discounted property is the right one. Ideally, you will have studied what was happening in 2005 to 2007, and then studied what went wrong in 2009 to 2011. Actually, since pretty much everything went wrong during that period, the focus should instead be on what went the most wrong – and applying those lessons to your current investment strategy. The most reliable strategy still appears to be to invest in established markets. The most attractive deals at first blush appear to be on the outskirts where the cost per square foot is much lower. However, as the old saying goes, location is everything, and you may still be three to five years away from the rooftops catching up with your investment on the edge of town, and you will struggle to obtain financing.

It may be advantageous to spend a little more to buy something closer that has a better track record. I also think it is a mistake to cut the lawyer out of the key analysis and decision-making processes. It is very likely that the property you are seeking to buy is very challenged from a legal perspective: the original developer may have had an entirely different plan for the property than selling it to you, and the decisions and choices made by that developer in 2007 when that property was developed (and the plan was different) will continue to haunt the property and its owner for years to come. A legal professional will help to identify those issues and ensure that they are resolved prior to your acquisition or, at least, ensure that you will know what you are getting into.

What do you think 2013 will bring?

Barring some major collapse in Europe or the dire fiscal cliff predictions, it would seem that the market will continue to lurch forward, likely unevenly, and sometimes after taking a step or two back. The trend appears to be a continuation of the past two years' slow climb out of the hole, and the retail markets appear to be stabilizing a bit, with fewer store closures and a few more store openings. The trend continues to go to smaller footprints for most retailers, which means the overall project sizes will continue to decrease. As the economy improves, the hospitality sector will brighten and new projects will commence. In general, clients will continue to press their legal providers to hold billing rates steady and to constantly increase the value proposition offered by such providers. The successful firms will be those that can provide these features for their clients by training up the mid-level associates and demonstrating their value with smart, concise and insightful work product.



Tom Muller
Co-Chair, Real Estate and Land-Use Practice Group
Manatt, Phelps & Phillips
in Los Angeles

How has your field changed over the past two years as we've emerged from the Great Recession?

The first thing I would say is that our field has changed rather slowly during the past two years' emergence from the recession. The recession of the early 1990s and the dot.com recession of 2000 saw much faster recoveries. This one has been steady but not very steep. In general though, deal flow has picked up, particularly in 2012, and workout work has fallen off to a trickle.

What are the most pressing legal issues affecting the commercial real estate market?

The most pressing issues in the current commercial real estate market are not legal at all. The issue is that the real estate market comprises a range of product types and qualities. The lingering effects of the recession mean that easily valued products like apartments are overvalued because of the huge amount of money chasing few deals. In the meantime, harder-to-value product like office and retail is still not seeing normal deal flow, except among the higher quality properties. At the low end of the quality scale, it's very hard to do a deal. The main "legal" issue that is materially affecting the market right now is the fiscal cliff coming this January when the Bush tax cuts expire and various federal budget controls kick in. This is creating a lot of uncertainty, which tends to make investors wait and see what's going to happen. On the other hand, I have several deals hell-bent on closing this year because of concern that capital gains tax rates will never again be as low as they are now.

What current issues seem to be affecting the success of commercial developments or properties?

I think the State of California is well known as a place where it is both more difficult and more expensive to develop real estate projects. There is an active NIMBY culture in many places in California, and the state's unusual Environmental Quality Act, requiring environmental impact review for most substantial real estate developments, even in cities, adds a lot of time and expense to the development process. It also gives development opponents a powerful tool to delay or prevent a project. Some California cities have well-earned reputations for hostility to development, and most have been hard hit by the state's fiscal issues. Many cities have had to reduce their planning staffs, causing project approvals to take even longer than they did before.

What advice would you offer someone who was entering the commercial market for the first time?

I think the best advice for someone entering the commercial real estate market for the first time would be to have a long horizon and focus on second-tier properties and markets. There is so much money out there looking to take advantage of the recession by buying fundamentally high-quality properties at deep discounts for a quick profit, that there is no way to compete with that. So look for solid properties and markets that, over the next 10 years, will ride out of the recession and produce very good – although not headline-worthy – returns.

What do you think 2013 will bring?

What happens to commercial real estate in 2013 will depend to a large degree on how quickly the federal government is able to resolve the uncertainty in its tax and spending policies going forward and, of course, what those resolutions are. Assuming the government resolves those issues quickly and in a manner not too different from the status quo, I think 2013 will be the year we stop talking in the present tense about the recession. We won't see a dramatic increase in the real estate economy, but enough continued gradual growth that we'll be back to what most of us consider to be a normal, reasonably healthy market with good price confidence and a fair amount of deal flow. And it's about time.