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# Practicing Law in a High-Pressure Market

*Real estate attorneys are challenged to provide guidance and speed of execution to meet the needs of aggressive investors and mitigate development risks in California*



 CALIFORNIA  
**REAL ESTATE JOURNAL**  
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## ROUNDTABLE ■ REAL ESTATE LAW

### PARTICIPANTS



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In the complex world of California commercial real estate, every deal, every lease and every development has at least one thing in common: There's always an attorney involved.

But in a rapidly changing real estate world are attorneys keeping pace with the demands of the industry? The negotiating table is a much different place today, where experienced players may just as easily sit across from veteran international and institutional investors as first-time investors.

The massive influx of capital into real estate means that deals must go hard in days, not weeks, while sky-high pricing compresses yields and makes everyone take a harder look at the bottom line.

The development world has changed even more radically. Land-use planning is tough when there's little land available. Whatever land you can find is sure to bring environmental and other entitlement challenges from increasingly sophisticated and educated opponents. New laws and local exactions combined with more complex development formats, such as mixed use and adaptive reuse, has made the entire process more expensive and fraught with potential liability.

The California Real Estate Journal gathered six commercial real estate legal experts to discuss how attorneys are meeting the challenges of the changing real estate industry.

Moderated by Michael Gottlieb, editor of the California Real Estate Journal, the panel included:

**LEWIS G. FELDMAN**, partner and public finance practice manager for Pillsbury Winthrop Shaw Pittman LLP;

**TIMI HALLEM**, partner in the real estate and land-use practice group for Manatt Phelps & Phillips LLP;

**JAMES C. HUGHES**, real estate, land-use and development partner for McKenna Long & Aldridge LLP;

**JEROLD B. NEUMAN**, partner for Allen Matkins Leck Gamble & Mallory LLP;

**PAUL S. RUTTER**, managing shareholder for Gilchrist & Rutter Professional Corp.;

**TIMOTHY L. WHITE**, executive vice president and chief operating officer general counsel for ARCS Commercial Mortgage Co.

### Experience Required

**CREJ:** How has the practice of real estate law changed with the industry?

**TIMI HALLEM:** I think it's a much more aggressive seller's market than most other seller's markets have been in the past.

For me, the biggest change is that when my clients are either buying or selling property, I spend a lot less time negotiating agreements. We spend much more time at an early stage talking about the potential risks and pitfalls in the transaction because, in some cases, there's pressure to put hard money down when you sign the agreement rather than at the end of the due diligence period. I think that's more pronounced now than it's been in the past.

**PAUL RUTTER:** I agree with Timi. I also think that it's driving the need for lawyers and their clients to be more creative in how to make a deal and

stand out from the competition. It's not always just price. It's not always just the deposit. It's not always the obvious things that make a deal different. It just makes everybody a little more creative but at the same time compresses our ability to work with the client and really get the kind of advice to the client that they need.

**JAMES C. HUGHES:** The current real estate cycle seems to involve more activity over a broader spectrum by more players in more markets than previously. Since the collapse of the stock market, there is more money from more sources in the real estate market and more lenders and sources of financing, making real estate less susceptible to impacts or abuses in any one sector. Underwriting by current buyers and lenders is more thorough and detailed, unlike the abuses of the past where scant attention was paid to the fundamental quality of the asset because of its rapid past appreciation.

Still, to get the deal these days at a decent

price, clients and their lawyers must move quickly, conducting effective and efficient due diligence and making entrepreneurial decisions regarding risk and future value. The properties they pursue may have several potential future uses and may be adapted midstream to changes in the market. Apartments as condominiums, retail including residential, studio space convertible to commercial or industrial and vice versa, lawyers have to have the foresight and skills necessary to anticipate and position their clients for the best result in this environment.

**CREJ:** Do you find that it's more challenging for new attorneys to break into this field under these conditions?

**HALLEM:** I think it is and I think that they're missing some of the opportunities that we had coming in to work on revising agreements and going back and forth in a buy/sell transaction. Even

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though the younger lawyers may not have been negotiating the agreements, they may have been simply listening to the negotiations.

There aren't really very many revisions to agreements anymore. You have to think long and hard before you tell your client you absolutely can't take this agreement because it could be the difference between getting a deal and not. So, I think it's harder to get purchase and sale agreement experi-



**W**e found that the time required to complete a transaction is compressed dramatically from where it was five or six years ago. We used to have an adage in our company – “45 days to glory,” meaning 45 days to take a loan from application to rate lock. If it was 45 days to anything today, it would be oblivion.’

— TIMOTHY L. WHITE, ARCS Commercial Mortgage Co. LP

ence, and there's more of an intense need for evaluating the entitlements, the environmental issues and other issues that your client is going to have if they're lucky enough to be the successful bidder.

**JEROLD NEUMAN:** I find that experience in terms of how our clients view our services is very important. It's not necessarily the driver of why we're not utilizing younger associates. The reality is the compression of time, either in the transaction or in how the client is looking at development, has forced us to turn to older associates when we hire. I think that's become a real issue. Where it does come into play is when you have to identify entitlement strategy or how to reuse a development or how to have a relationship that will cause this development or opportunity to be different for my client than it will for another developer in the area. That is only driven through experience. And we're finding a lot of need for that.

**TIMOTHY WHITE:** We found that the time required to complete a transaction is compressed dramatically from where it was five or six years ago. We used to have an adage in our company – “45 days to glory,” meaning 45 days to take a loan from application to rate lock. If it was 45 days to anything today, it would be oblivion.

The average processing time to get a loan approved in our company is now 17 days, and that's the result of the tremendous influx of capital, the amount of information that's available for real estate lending, and the pressure that all of that places on permanent lenders to respond quickly.

We find that in order to meet those time requirements as far as the legal end of it goes, it's really important that we work with experienced lawyers or well-supervised junior associates who really under-

stand the rules of engagement and don't try to remake a transaction. That day is over. We can't be doing anything of that sort in the business that we are in as permanent lenders.

**RUTTER:** Tim's input is an example of why it's hard as a firm acting as outside counsel to be able to train the younger associates and really bring them into deals so they understand the give and take in a deal.

A lot of the young lawyers doing deals today must assume that purchase transactions are done without reps and warranties from the seller and are always “as is.” Well, that is not the case. It's been the case in the last few years. But those poor associates that have really never had the experience of negotiating a set of reps and warranties from a seller won't really understand how to do it until the next cycle. But your example of the pressure on outside counsel is what makes training difficult.

**NEUMAN:** There's also a dynamic that's happening. You have a sophisticated financial market, you often have an inexperienced land purchaser or developer, and so the experience from the financing source is looking to the lawyer for the experience in how the deal is going to get structured and move forward because they don't necessarily have the faith in the developer or the investor as they come into the marketplace. That drives people to look toward experience and demand it.

You have to utilize your resources in a firm more adeptly in terms of marrying the right associates and teams to the right development or acquisition.

**LEWIS FELDMAN:** There's no doubt that we're living in an environment which basically rewards both legal and financial efficiency like never before. Rates may be increasing, but I think that everybody is generating a lot more information than ever before and if you're not multitasking you're falling behind. I think the clients expect to get those efficiencies and they want the experienced lawyer.

**HUGHES:** Versatility is the key. Inherent value is the mantra. There has never been a better time for real estate attorneys to demonstrate their value to their clients. Anticipating what could happen with a property or project, both good and bad, gives the experienced practitioner the opportunity to plan for these events at a very early stage, protecting the client's interest, the project, the entitlements, the permits, or the lender's interest when change occurs in the future.

The most important skills for today's real estate practice are foreseeability and proactivity. The deals require it, especially when your client is out of the starting blocks almost before you have the letter of intent on the deal.

### Speed and Prudence

**CRE:** Is there an essential conflict between the efficiency and the speed that you need to be able to pull the trigger on a deal today and the prudence that an attorney is supposed to bring to his or her client in a transaction?

**FELDMAN:** I think once a year everybody should review their malpractice policy. It keeps one grounded in approaching project due diligence and ensuring an appropriate level of care.

**HALLEM:** The fact that everyone is making purchase decisions without the time to look into all aspects of a piece of property before you put in a bid means that at least sophisticated real estate people understand that the hard work of finding out what you're buying is going to come after you've already committed a significant amount of money to the deal and there is no negotiation on the purchase agreements so you're not going to be able to draft your way around it. You're basically making a bet on the property with nonrefundable money because you're hoping that what you find will be what you needed to develop the property in the way you have in mind.

The need to be careful and thoughtful and to bring that prudence to bear requires a little bit more time than the time that you're allotted to get a purchase agreement signed and be the winning bidder. It may not be much. It may only be 30 days.

**NEUMAN:** Aren't people also coming in with an exit strategy where the horizon is much shorter than before, so that the way that they're assessing risk is very different because it's a much shorter period of time?

**HALLEM:** Yes, but if it's a development project, for example, and you're buying land based on what you hope you can get it entitled for and bring it to market within a relatively short period because of the returns you're paying to your investors, you're still taking a risk.

Gone are the days when you could have an entitlement contingency before you had to close. It wasn't that long ago that a lot of us were doing deals where your obligation to close was contingent on getting full entitlements from the local government. I don't see that very much anymore.

**NEUMAN:** Well, I'm grateful for it because it's making my practice a lot more interesting. People are buying property and needing land-review services in a way that they never had before because they have already taken it on the come and they're looking to us to make sure that we can get them out of the problem if the problem arises.

**HALLEM:** There's no doubt about that, but it's just a different environment because not very long ago we were doing the old contingencies on getting your entitlements. Now people will buy property when it's subject to a moratorium in the hope that it comes out the other end with an ordinance they can live with.

**FELDMAN:** I think developers and investors are looking for the opportunity to develop or invest anywhere because of the price appreciation of land and the urbanization that's occurring. It's just straight demographics, and I think we're going to see that for quite a bit of time. California is growing and will continue to see its population increase over time.

Market participants are waiting for things to dip and move around. The beauty of the experience lawyers have is that you've been through the cycle. You've been through the storm. You can advise people. You can work as teams. I find there's a shortage of that experience.

**RUTTER:** I agree. To answer your question, there is tension between doing deals quickly and doing them correctly, but I feel I am providing good legal services by advising a client about the risk of a transaction, letting them make the business decisions and not imposing my own business judgment whether this is a smart business deal or not.

**NEUMAN:** I'm finding many clients who look to our services as almost business advisers because it's not just how they're playing in the marketplace, but what can they expect from the public sector? What's their risk going to be as they go through the entitlement process from a cost perspective? How do we analyze the cost for infrastructure development or the cost of a living-wage ordinance or a cost of any of those community benefits that might be aligned with their entitlements? So we say to them, “This is what your risk is. This is how much that is going to cost you. This is where that business is going to be. This is where you're going to end up on a cap rate basis.”

**HALLEM:** I think that's part of the risk analysis. It goes into what your returns are likely to be and what the likelihood is that you're going to get where you need to go.

The risk is that your client is going to have to spend so many hundreds of thousands of dollars and so many years in trying to get a project entitled

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that at the end of the day somebody could file a CEQA action and hold them up for another six or nine months. Or a client might have to give up entitlements because even if they get the residential mixed-use project they want, they're going to have to pay give-mes to the local government and then the client has to say, "That's still enough return that I can live with it at the end of the day even if I get the bottom end of the range, or at the bottom end, it doesn't pencil out."



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**FELDMAN:** But I think what Jerry is saying makes a lot of sense in that you're dealing with risk analysis because their capital is at all different levels within the market — everything from very highly secured kinds of security all the way down to very loosely secured or unsecured credits — and there's money in each one of those segments.

One of the things that we're asked to do is to assess what the risk is on this thing. I think what Paul is saying is you assess the risk, you let the client understand really what level of economics the transaction could come out with on the other end and where it fits into the cake that we all bake in terms of economic and financial efficiency. You then provide that deliverable to the client.

**WHITE:** In our business, which has nothing to do with the entitlement side of things where the world is completely different, the amount and the quality of the information that's available is tremendous compared to what it was five or 10 years ago. That makes it possible to make good decisions relatively quickly, at least much more quickly than decisions were made in the past.

We're seeing so much more information coming from the borrowers themselves. The lease tracking services, the sales tracking services are so much better so better comps are available today than in the past. Engineering services also are very quick and better able to respond, and the environmental database is much more comprehensive.

Those factors contribute to making reasonably good-quality decisions much faster than we've seen in the past.

## New Investors, New Challenges

**CREJ:** We're focusing on people who come in with a level of education and sophistication that makes them well aware of the risks they face. But clearly we've seen in this cycle a massive influx of investors with money who are not sophisticated. And even if they're sophisticated players, such as foreign investors from Australia or Germany, they may not know what they're getting into when they come into Southern California, yet they still need to pull the trigger quickly. Is this an area where your client expectations can fall apart?

**HALLEM:** I think that's true. But I think you still do the same work as a lawyer in terms of describing risk.

I think no matter what you say to try to manage people's expectations realistically, sometimes, their cultural experience will keep them from either hearing it or believing it. Yes, maybe they're just being conservative. But you can't change their expectations. All you can do is do the best job you can to give people your honest perspective on it.

**NEUMAN:** Are you spending more time educating people about those expectations now than you did before?

**HALLEM:** You're spending more time making sure you're clear about what you think the parameters are, but in some cases we're all products of our experience. And if your experience is 100 percent different, then it's just not going to be meaningful to you. No matter what you say, people see things through the prism of their own experience.

So as a lawyer that doesn't change what you say, but you can't let yourself be disappointed if after you've said something 20 times and at the end of the day when what you said comes true, your client who came in with completely different expectations says, "But that's not what I thought was going to happen." Sometimes they're just not listening. They can't hear. They can't absorb what you're saying. It's just too foreign to their personal experience.

**NEUMAN:** I understand.

You have clients that are coming in saying, "I've been buying assets for 20 years and just living off of the income that they generate, and now I can't do that. Land prices have gotten too high, so if I want to come into the market now, now I got to do a development play that I've never done before. Explain to me what that means."

You're taking them through the process and educating them at the front end and helping mold their expectations often through our experience as lawyers and what we've done in the past. I've found that people become very reliant on you and ask you to help assess their team and help them understand what each of the team members are going to do as we move through a development project. Or they may be moving from retail into housing and they don't understand the housing market nearly as well as they did the retail market.

## Attorneys as Consultants

**HUGHES:** Every deal is on the fast track and relationships are the key. The best assets are often obtained on the basis of business and corporate relationships established prior to the availability of any asset.

By the time a property hits the broker listings, buyers are going to have to do something exceptional to get the deal. This can be avoided by moving upstream, targeting the real estate players who have or want the kind of product you want to acquire or sell. Doing deals in packages, rather than one-offs, is preferred because it conserves resources and is more efficient.

The lawyer's relationships — with other clients, counsel, brokers and others — have to be harnessed to the deal to get the client the best advantage.

I've handled some deals where neither the principals nor brokers wanted to deal with one another. The lawyers did the heavy lifting and got the deal done.

**RUTTER:** I see my role much more now as the consultant on the team more than I ever did before. Often in deals in the past the team would come to you and you'd be added to the team late in the game. But now the clients are asking up front, "Who do you know that's done this kind of work before? And can you help me assemble the team?" This is happening all the time.

That just shows the value of senior lawyers. All of us at this table are pretty senior, and I think we're seeing the value of all these experiences and relationships we've had over the many years come back and have tremendous value to a client. You can't measure the value you add to a deal if you assist a client with assembling the right team.

**HALLEM:** I also find that experience adds value because on the entitlement side, especially among the smaller cities, there's a lot of moving around. Often I will walk into a city somewhere in Southern California and find that I have a prior relationship that at least gives me a feel for what the person's like, what they are concerned about, how to work with them. That is a level of comfort walking in that wouldn't be available to the client otherwise.

**FELDMAN:** I think what you're saying is vitally important. Credibility and closing ability are two critical factors. And once the credibility is there, then people can move much more quickly to deal with price and terms and other things. That seems to be one of the biggest currencies provided by that senior attorney.

**NEUMAN:** You're absolutely right. A lot of these processes are being shadowed by layers of teams like I've never seen before.

**HALLEM:** Lots of lawyers.

**NEUMAN:** Lots of lawyers, lots of consultants looking over everyone's shoulder because there's so much money at risk, things are moving so fast, and any hiccup has huge ramifications. Everyone wants to cover their position. So it's amazing the number of consultants looking at any given transaction.

**HALLEM:** And that's exacerbated by the increase in construction costs and the feeling that this market may never come back again. People are very intent on getting their projects done quickly and efficiently and out there in the market.

**RUTTER:** On the purchase and sales side, I've been now called to meetings where my client is a bidder at a beauty contest and the seller wants the lawyer for the buyer at that meeting to see if we're credible in being able to close a deal. I never saw that before. And now we're being requested to attend these meetings and show that we can do a purchase transaction and that we understand all the elements of the waivers and releases that are being given to the seller and we're never going to come back to the seller again. It is amazing.

**FELDMAN:** It is amazing.

## Negotiations: A Thing of the Past?

**CREJ:** Let's talk about transactions and how they're changing in the current marketplace. Where do you see the key changes that have occurred and how are they not only affecting your practice but the way that deals are being executed?

**RUTTER:** I do a lot of work in leasing, finance and joint ventures, and in all three of those areas I've seen tremendous pressure on speed of execution, and therefore on the ability to work with people we worked with in the past.

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For example, I just did a 100,000-square-foot lease transaction that we completed in three days, and that was done because we had worked with the other side before. We knew what they expected and we drafted a document that we could live with from prior precedent so we got the entire transaction done in three days which is unheard-of. That's because of the pressure of competing deals for the same space, and that's just an example of a lease deal.



There has never been a better time for real estate attorneys to demonstrate their value to their clients. Anticipating what could happen with a property or project, both good and bad, gives the experienced practitioner the opportunity to plan for these events at a very early stage, protecting the client's interest, the project, the entitlements, the permits, or the lender's interest when change occurs in the future.

— JAMES C. HUGHES, McKenna Long & Aldridge LLP

But the same thing is true in finance. You've got to make standard documents that are livable for the vast majority of your borrowers.

**HALLEM:** In a lot of cases my clients go back to the same lender and we start with clean documents and a red line that compares them to the last deal that we did with the lender so that we don't ever go over the same ground again. We do the same thing with financial partners.

Negotiation is basically a thing of the past right now. You are very, very hesitant to suggest changes that you don't think are absolutely essential because the sellers are handing you their agreement and telling you they're going to look unfavorably on changes that you make to the agreement. I think really we're all living off of what we negotiated in the past to some extent and trying to improve slightly upon it around the edges but really not making wholesale changes and documents at all levels.

**WHITE:** We're in an era of what we refer to as mass-customization of our loan transactions. We are striving to achieve high levels of volume with a relatively small amount of negotiations. There's a relatively limited number of issues that can be negotiated on our permanent loan transactions, and all of that has been driven by the need for speed and the need for standardization in the mortgage securities market.

Those are huge dynamics that are changing in our business today.

**RUTTER:** You talk about the shrinking time. Have you also seen a shrinking of the cost of transactions as you reduce the time?

**WHITE:** The costs are volume-driven, so they are affected most by how much business we're driving

through the system. When the volumes are up, the costs go down and vice versa if we have a fall-off of business volume. That's really the dominant criterion. But the changes that we are making are going to allow us to produce the business at a lower relative unit cost at whatever the volume is.

**NEUMAN:** Buyers and sellers now tend to be walking into the negotiations with the lender in mind more than they ever have because they understand that time compression. And there's a lot less discussion about whether lenders will agree to these deals.

**Playing in a Bubble?**

**FELDMAN:** It just shows you what an increased asset value and a perception of increasing value will do, which comes back to the real question of whether we're all playing in a bubble again and are we going to dust off our bankruptcy hats at some point?

**HALLEM:** I think the answer is probably yes but not as bad as the last time because you don't have the savings-and-loan deluge of bad loans, vastly overpriced assets and vast amounts of overbuilding. There's a lot less speculative building than what you saw in the '80s. There's some of that in the warehouse market, but it appears that as soon as you build it, they do get filled.

**FELDMAN:** I agree that you don't have a bubble on the development side, but you have it on the transaction side. You have some crazy money chasing cap rates that will push people to buy product that they ultimately can't afford, and the shake-out will come not in overdevelopment but in market compression and cap rates.

**HALLEM:** On the development side you don't have problems of the massive office building, etc.

I do think that the condominium-conversion market may be the first place we'll see a bubble as rates rise. You're now in a situation where developers can't afford to build rental housing because they can do so much better on condominiums and there are not enough apartments for people to rent, but people can't really afford to buy condominiums as interest rates go up and people use these screw mortgages to buy their first condo.

**RUTTER:** That's where I get concerned. There is a lax underwriting by some lenders in these markets. I think that is the potential. Maybe it's in condominiums exclusively, but I don't think so.

**HALLEM:** That's the leading edge.

**FELDMAN:** Yeah, I'm just not sure that we truly understand this option phenomenon that's occurred because one of the greatest changes — besides the technology that allows us to vastly compress the speed of processing, entitling and closing transactions plus on the brokerage side packaging things up on the front end to give to people to facilitate the change — is you've got people who are able to take money out of their own homes and take an option on a condominium in Las Vegas. If the price goes up, they'll close. Then they'll flip. If the price goes down, they'll get their money back. This is going on in Las Vegas. This is going on in Miami. So I think you first have to see the deterioration in the option market itself before you see the deterioration in price.

**CREJ:** On top of that aren't you seeing a lot of people buying homes as investments rather than residences where they leveraged themselves to buy their original home and now they're leveraging themselves even more.

**FELDMAN:** Last year there was \$69 billion in refinancing. That's a ton of money to be taken out. And then you have things like the elderly who are shifting into reverse mortgages. That's doubled in the last year. There's just an incredible dynamic.

**NEUMAN:** Is that a relaxation of the lending criteria itself, or is it just a recognition of the changes in the marketplace?

**WHITE:** In multifamily loans there has been a little bit of relaxation in the underwriting standards. It used to be you could never break the 1.25 debt-coverage ratio in underwriting a permanent real estate loan, and it's possible to do that on certain transactions today. That is a factor of the increased competition and the willingness of the conduit lenders to make more aggressive loans than the agency lenders have been willing to make.

**RUTTER:** It's fascinating to me that you do see this. And what about the credit underwriting? Isn't that another area where you see lenders go to a lesser credit for the carve-out guarantee?

**WHITE:** I think the credit issue may be a little deceptive because the credits of our borrowers have improved. The borrowers have all benefited from this tremendous improvement in real estate values. We're looking at numbers that are significantly better than what we have historically seen when we look at the credits of the borrowers. So is that value reflected in the balance sheets of our borrowers real? I think that's a very good question.

We have \$13 billion of loans in our portfolio and there are no defaults right now. It's a great time to be a borrower and it's really a great time to be a lender although there is so much competition.

**FELDMAN:** Is that because there is a secondary market to sell all your bad loans in?

**WHITE:** No. All of our loans are sold upfront and we retain the service rights on them so we know what happens to them.

**HALLEM:** But I think we are approaching a point where people are buying single-family, whether they're condos or homes for investment, taking money out of their primary residences and putting it into investment properties on the assumption that they can then rent them and at least cover their costs while they watch the value go up and leverage it into the next investment.

If people stop being able to afford to pay enough to cover the costs of the condo that you bought for investment, that concept is going to come to a screeching halt. Most people are not planning on negative cash flows to support all of their investment property, and that's really the risk because incomes are not going up in the country.

Interest rates are going up now. Gasoline expenses are going up. And as people get squeezed, are they going to be able to afford to pay for their primary residences? And if not and rents drop, then what's going to happen to all these people who have made all these investments in single-family rental properties?

**RUTTER:** But I think that the return expectations of people have declined.

We're always looking at this from our perspective of having been through the real estate cycles of the '70s, '80s, '90s and now the 2000s. We have certain expectations about real rates-of-return. I think there may have been somewhat of a fundamental shift in that real rate of return expectation. Part of that is driven by the gyrations of the stock market because people saw the intangible assets of the stocks and bonds and people want hard assets. They're driven to take a lower rate of return and have a hard asset, which they think will be less volatile. Maybe that will be borne out so that there's a longer-term bull market in real estate than we're all expecting.

**HALLEM:** I think lower rate of return works. I think negative cash flow doesn't work for a lot of people, and that's what I'm concerned about. How much of a cushion is there before some of these properties that individuals bought for their own investment switch to negative cash flows and they just can't

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afford to keep up with them?

**WHITE:** When you work that through, think how that will work in our system. There are probably a couple orders of magnitude that need to occur before the apartment owners start to have any serious problems because there is a group of homeowners that got into aggressive mortgage loans, and if they can't make their payments, they're a logical group



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— TIMI HALLEM, Manatt, Phelps & Phillips LLP

to migrate back to apartments. So there's a level of trouble that the apartment world can probably sustain before the owners of the apartments experience any real pain. Now, if we have a down cycle and we get through that wave, then the next wave might be a different story. But initially the outlook for the apartments looks pretty good. It's very healthy today, and it looks like it's prepared to withstand at least a modest downturn.

**Mitigating Risk**

**CRE:** Do you think that the risk that you're seeing in the marketplace is being incorporated into the pricing of property?

**HALLEM:** I think pricing of property now is whatever you think you can get and then some.

I just don't think the prices have any bearing on the reality of the risks. They really are just a function of the money out there chasing something to buy. They'll buy property at a lot more than even I thought it was worth.

**RUTTER:** I'm working on a sale transaction right now where we went through the normal bidding process, we went through a best-and-final, and in the best-and-final round we had at least five bids come in above what we thought we would get. We went to a second-best-and-final round, and that got even higher bids. My client is just thrilled.

That's driven by the tremendous demand for real estate anywhere in the city at this point, and I think what Timi said is true; This is a situation where the client on the sell side is just amazed by the inter-

est in their property. They underestimated the demand for their property.

**NEUMAN:** Or an expectation of greater reward. It's not the risk side of the ledger that they're looking at. It's that the market has been rising at such a significant pace. The opportunity to grab money that's out there doesn't seem to be slowing down in terms of its capacity to fund these transactions. That is making people look more and more toward the reward side and forget about the risk side because the market will adjust for itself.

**FELDMAN:** That goes under the definition of a bubble, doesn't it?

**NEUMAN:** The question is how big of a bubble is it and when does the correction happen? When does that bubble deflate?

**Entitlement Risk**

**CRE:** We're seeing investors move into the development side. CalPERS, for example, sold a massive office portfolio to recapitalize and partner with developers. But with development you're getting into risky territory, particularly in California, due to entitlement risk. How do you see this lack of available land impacting entitlement today and the investment decisions being made?

**HUGHES:** The scarcity of developable land at reasonable prices and the cost and length of entitlement processing in areas like Los Angeles are a problem for middle-market or affordable-housing projects. Developers have to pack so much density on their sites to make them work that they multiply the impacts on the surrounding areas and encounter local resistance to their projects, which is much better organized and savvy than it once was. Luxury projects can often pencil out economically, but that is not where the need is.

**NEUMAN:** It's kind of a dual trend in the sense that you have investors who are looking at how to maximize values for property that they may or may not have overpaid for. You do that by seeking greater entitlement, so you've moved toward mixed use. And, at the same time, you see governmental agencies moving toward a view that they can't keep allowing the expansion into greenfields and so they start looking for infill. Fortunately, at this moment in time, those two lines have crossed and it's made it very fertile ground for investment into inner-city and urban areas.

From a retail standpoint, you have retailers who are looking at urban markets in a way that they've never done before, so cap rates can adjust and those properties can be successful. And you have the housing boom that's just not stopping. So the lack of land has been a trigger to assist with the bubble or the boom, but it isn't a filter for it by any means. It's not slowing it down.

**HALLEM:** We're seeing a lot of urban-infill projects, a lot of aggression in being willing to undertake brownfield properties, properties with environment risks. A lot of investors look at underused buildings and the ability to convert them to housing or other uses. There is a lot of examination of ways to get density bonuses because in many cases your urban property and infill property has additional costs attached to it because it's not a blank slate, and so you need to look at increased density or mixed uses or some other way to increase the returns to justify the costs.

Most cities now have become more realistic and understand that it's in their interest to get good use of underutilized or abandoned property in areas of the city that have not gotten a lot of attention recently.

But you can never underestimate the ability of neighbors to like anything that they have over the potential of anything else that might come in. And so even when you look at it and say, "How could anybody not prefer 'X' to what's there now?" There

will be someone who will say, "I just don't think you should build that."

**NEUMAN:** That is true. But you also see a rise in expediting ordinances, which provide developers with the ability to move through the process more quickly if you are targeting properties that the governmental agencies feel can be converted to other uses. So you have a processing compression for certain segments of the market and certain product types.

Now, Timi is absolutely right. That compression can fall apart in the face of homeowner opposition, which is much more organized and much more educated than they ever were before. That's a risk analysis that has to be undertaken. But the trend is to try to find processing compression for the infill project.

**HUGHES:** Luckily, infill development and adaptive reuse provide opportunities for more environmentally friendly ways of reclaiming abandoned sites and existing infrastructure for development without contributing to urban and suburban sprawl. Developers of those so-called "smart growth" sites often face challenges lining up sufficient sources of funding to pay for environmental clean-up and building-retrofit costs because traditional financing will not be enough. Avoiding environmental liabilities and dealing with the long timelines of regulatory agencies caused by chronic underfunding and understaffing are also a hazard of such projects.

These projects are lengthy and complex, requiring a level of experience and sophistication much greater than that required for the typical real estate project.

**Agency Help or Hindering**

**CRE:** We've mentioned expediting ordinances, but there are also inhibiting ordinances that we're seeing out there. So, for as much as ordinances, such as Los Angeles' adaptive-reuse ordinance has provided tools to support development, aren't there others that have created conflict?

**NEUMAN:** I don't know that those ordinances in and of themselves prevent growth. Those are things that you deal with at the end of the day. If you have inclusionary-zoning ordinances, you look to bonus density or you look toward the public-finance sector to help offset costs. It creates an additional processing element but it doesn't necessarily change the timeline.

**HALLEM:** The ordinances that are the most troublesome for development are generally in cities or counties where you're not talking about infill development.

I think the tendency to go toward referendum and this notion that zoning should be done by popular opinion makes you wonder why you bother to have a local government at all. It is very dangerous because there is no way in the development process that you can truly explain to people in 30-second soundbites or postcard mailers the good and the bad about your project, and you can't work with the public to make your project better. It's just really an unfortunate way to do urban planning.

**RUTTER:** It's also being used as a tool for developers to stop competition. It's a sad use of the referendum process to let that happen.

**NEUMAN:** You find that as you look toward inclusionary housing and prevailing wage that those are elements that seem to have caught on partly because the marketplace has taken off and the public view is that we need to preserve a portion of the marketplace for people who are being completely priced out of the market. But the pricing itself is helping adjust for that.

The area that has threatened the marketplace is where income streams have been taken off the table. For a little while there you saw signage as

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being a great tool to fill the gap in terms of market return. Now signage isn't available in most areas of the city of Los Angeles. So now the question is where does the market turn? That's where you're starting to see the give and take of how you negotiate on the other items that are cost items and not just absorption issues.



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— JEROLD B. NEUMAN, Allen Matkins Leck Gamble & Mallory LLP

**FELDMAN:** One phenomenon that we're all experiencing is the increase in local-government property taxes. And the income streams that are now being made available, such as signage, are sometimes difficult to get pledged back to projects due to state fiscal issues. But they are there.

**NEUMAN:** In the late '90s, people were looking heavily to find subsidized projects where they were turning to government for a lot of money. That trended away because there were too many strings attached, so people moved away from asking for government financing. But now there are huge pools available causing people to ask, "How can I fill my income gaps with that money?"

**HALLEM:** Although for residential stick development you then have to weigh the prevailing-wage costs against that. If you start taking government money, then living wage in L.A. or prevailing wage statewide, you can't make up the costs of prevailing wage for what would normally be nonunion wages so it's hard to take a subsidy.

**FELDMAN:** It depends on how one structures that subsidy to avoid triggering prevailing wage on the entire project. That's really the art of that field.

**HALLEM:** That can be done in some cases, but in many cases it can't. It just depends on whether you can separate it out.

**FELDMAN:** Right. In those circumstances, however, there are other programs that might be available, for example, subsidies that can be provided through leveraging housing set-aside funds or leveraging the mortgage-revenue bonds to give

Californians a piece of the American Dream. In today's market this is likely a condo, of course, in many places, but it's homeownership nonetheless.

**NEUMAN:** We are doing a lot structuring mechanisms to help move around the effects of the prevailing-wage issue. But a lot of developers are finding where they were once assessing prevailing wage at a premium of about 20 to 24 percent, they're now starting to see that margin has compressed to be 15, 12, 10 percent, and so it's uncertain what the impact is, especially as construction costs rise.

### Insulating from Infill Liability

**CREJ:** We're seeing increased costs coming into the market as a result of this movement to urban marketplaces. But we also see an increase in potential liability for the people who are coming into these markets. How you can insulate your clients from the potential liability when they're doing those kinds of projects, and at the same time recognizing that the costs are higher?

**HUGHES:** Construction-defect liability in California, despite recent legislation that has complicated rather than simplified the area, is a significant barrier to development. The per se liability of the builder, combined with the difficulty of obtaining insurance at reasonable cost, is the single biggest factor discouraging those who would otherwise bring residential product to market. Instead, developers go to other states in the Western United States where the liabilities are more manageable and foreseeable.

Also, the tight regulation, timing and expense of California's approval of common interest associations and condominiums is a factor, when compared to other states' self regulated systems.

**RUTTER:** Well, there's no question that in the condominium arena with the cost of insurance being a major burden, I've had several clients look at how to do projects and come away convinced they can't do them because of the insurance costs. That indicates to me that there are a lot of people out there that are experiencing this problem. I'm not sure whether they're paying through the nose for insurance or whether there are other mechanisms that have come up, but the savvy people I know that are looking at these projects are very concerned about the defect-liability issues and the staggering insurance cost numbers that are quoted to them. They're paying \$3 million in premiums for \$6 million of coverage. Those are staggering numbers, so it doesn't make sense to them to do that.

**HALLEM:** On the bright side, the science has gotten better. The consultants are much better at finding environmental issues and looking at structural and seismic issues. The level of what people can figure out and the computer modeling especially in the seismic area has made it so that you know a lot more about property before you reuse it than you ever did before.

But I think Paul is right. The construction-defect problem is one that has not been solved notwithstanding the California Legislature's effort to do something on that a few years ago and the insurance costs remain very high.

The other thing is that no matter what people say about wanting to live in mixed-use areas, often the reality is not what they thought it was going to be. There's noise even in nice areas. That's part of urban living, which people in densely populated cities like San Francisco, New York and Chicago are used to. But people in L.A. are not used to the fact that if you open your window at night, you may hear people until 2 or 3 in the morning.

It's just an expectation issue, and people have to come to grips with it if they want to live in an urban setting.

### Legislation and Court Decisions

**CREJ:** There are a number of laws and court decisions that have come down recently that have had significant impacts on the real estate industry. What are you tracking, whether it's legislation or legal decisions that we should be watching?

**HUGHES:** The *Kelo* decision makes no new law in California where state redevelopment law has permitted use of eminent domain for acquisition of private property involving residences, provided certain governmental findings are met and public hearings conducted.

But it has focused the public debate on where a man should lose his castle to redevelopment and there is legislation working its way through many jurisdictions nationally, including California, to limit the right. This would be unfortunate because it is not typical for redevelopment agencies to abuse their power of condemnation. Moreover, the elimination of blight and creation of new wealth created by redevelopment can be a significant benefit to downtrodden areas. We are likely to see more than one municipality ban condemnation of private residences.

**HALLEM:** One of my partners is one of the country's biggest experts on eminent domain, and his view is that *Kelo* will have relatively little impact in California because redevelopment laws are such that you can't use it in the extreme way that they were trying to use it in New London.

I understand why people react badly to it. How would you react if they told you your house was really now better suited for a shopping center so you're going to have to move out? That's a very difficult concept.

**FELDMAN:** Make me an offer.

**HALLEM:** Well, in California where hotels and shopping centers are the only things that produce local sales tax, I'm sure there are a lot of cities that would be happy to take out residences and put in a Costco. That's how you fund your city. But I think it's going to have relatively little impact in California because of existing restrictions.

**NEUMAN:** I think that's right unless the Legislature decides to tinker with eminent domain in a way that we're not anticipating.

**FELDMAN:** On the other hand, *Kelo* gives the California redevelopment agencies legitimate authority that their programs work.

**HALLEM:** The most dangerous development legislation that you see coming up year in and year out are all of these efforts to change CEQA to divorce the developer from the process. There was a bill last year that said the developer was not supposed to talk to the environmental consultants. Well, how are they supposed to learn what it is you're building? They're not going to learn that from the government. How does that work in the context of a year-long environmental-impact report process?

Unfortunately, you have a legislature that, because of term limits, doesn't really have time to master some of the complexities of statutes like CEQA, which are very complex, the relationship between the developer and the local governments and the public. They keep introducing bills that are just going to make the process impossible and less informative.

You have to rely on the real estate industry lobbyists year after year to go in and say, "Hey, what you're proposing won't work at all." They have to keep doing that because the next year there's a whole new crop of people for whom this is all just a blank slate once again.

**HUGHES:** Prevailing-wage requirements for redevelopment have increased the feasibility gap of every applicable redevelopment project in

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California. These projects are difficult to finance with traditional debt and equity sources and usually require governmental subsidy. Laying on a prevailing-wage requirement, which is not new but is more comprehensive than before, simply increases the amount of required governmental subsidy so the taxpayers pay more to pay union wages for what otherwise would have been nonunion wage work. It's pandering to a political



**'A** lot of my clients are doing value-added projects, so there are opportunities other than just buying and selling deals and trying to lease up some old space. They are really thinking of ways to add value to a project, and that's what makes their business models successful, and that's where we can help them be successful as opposed to just competing head-on in a horse race.'

— PAUL S. RUTTER, Gilchrist & Rutter Professional Corporation

constituency, in my opinion, not good redevelopment policy.

Previously, we had some room to argue to keep certain projects and certain project work out of the prevailing-wage category. That is much more limited now.

**CREJ:** Do you think the real estate industry could do better lobbying on its own behalf in Sacramento?

**HALLEM:** Yes, although the industry has got quite effective lobbyists in California. I'm on the board of NAIOP and we share the same lobbyists and I'm surprised at how effective they are. They may not be as good as they should be, but they have been effective in countering well-intentioned but impossible-to-implement legislation.

**HUGHES:** Regulation will increase, not decrease, in response to the level of perceived threat.

Mold and water-infiltration disclosure and regulation will increase as the regulatory standards develop and the plaintiff's bar wins large jury verdicts. Regulations regarding terrorist-related identification and money-laundering laws will increase as incidents occur, plugging holes in the real estate and financial system exposed by these incidents. Seismic laws will evolve further for older buildings as they are increasingly converted to residential use and the potential loss of life is assessed.

**A Tighter Regulatory Environment?**

**CREJ:** If we see the market go bad in a big way do you see a financial environment that may become

more tightly regulated?

**WHITE:** It is an interesting question that if we see a downturn, whether the conduit world can respond reasonably well to adverse conditions? Will the conduit lenders, the master servicers and the special servicers, which are responsible for administering the conduit loans, have the judgment and the legal ability to make the right decisions or will they be hamstrung by tax concerns or rules that have been set in stone at the time the securities were issued? Since we've never been through a down cycle with the conduit business, I don't have an answer to that question, but it's a very interesting question as to how that would all play out.

**RUTTER:** I agree. I think related issues are going to be whether the structures that everybody set up in their financings for the SPEs and bankruptcy remote protections that the lenders insisted on, whether those will stand up to scrutiny and be enforced or whether they will be pierced or have creative bankruptcy lawyers figuring out ways around all those protections. That might result in changes in laws should they end up failing and people don't have the protection they thought they had there might be some legislation that comes up.

**FELDMAN:** The real issue isn't whether in an extreme episode of historic economic difficulty that regulation doesn't come in. The question is: Where will it be applied and from whom will it emanate? Will the changes come through federal securities laws, or will it come through tighter state regulation. Or, as seems to be occurring more frequently these days, will it come through New York Attorney General Elliot Spitzer's office?

**HALLEM:** Going back to what Tim said, one of the dangers is that if the conduit lenders are not facile at being able to deal with downturns and do the kinds of workouts that we all spent so much time and effort working on in the '80s, they're going to have no choice but to foreclose. If there's no there then when the time comes to deal with the downturn, you're going to end up with foreclosures, and that has a massive impact.

**FELDMAN:** However, so much wealth was monetized the last time there was a problem like that. More money was made then than during previous history of the world, according to the Milken Institute.

**HALLEM:** Because the federal government took it in the ear. Basically, they foreclosed and sold at a fraction of its value huge amounts of property, but now you have these securitized lenders and it's not we the people that will bear that cost. It's going to be the investors.

**FELDMAN:** The question is the underwriting. I would venture to say that if you go to most major lenders today, they're underwriting their projects with the same level of discipline as before.

**NEUMAN:** If not more because of regulations and what we've seen in the marketplace.

**FELDMAN:** Right, but is the discipline enough? Do people put artificial caps on it? Does someone get to blow the whistle to say, "It's gone too high?" I don't see that happening. I see a reactive force at play for lawyers.

**Final Thoughts**

**CREJ:** Each of you brings a different specialty to the table. What's the best advice that you're giving to your real estate clients and how are attorneys helping to resolve the major issues facing the real estate industry today?

**HALLEM:** It's very easy to get caught up in bidding

wars and aggressive outlooks, and they may or may not be correct. When you go into real estate transaction or an entitlement transaction, you have to decide what your bottom line is. What do you need? And if you can't get that, then look for the next deal. Don't get caught up in the game just because you're playing it.

**RUTTER:** My advice to my clients is similar in some ways. In order for a deal to be done by my clients, they have to think of what they can uniquely add to that deal and make it something that works for them. A lot of my clients are doing value-added projects, so there are opportunities other than just buying and selling deals and trying to lease up some old space. They are really thinking of ways to add value to a project, and that's what makes their business models successful, and that's where we can help them be successful as opposed to just competing head-on in a horse race.

**NEUMAN:** I guess the first thing I tell my client is I'm so happy you asked that question first because waiting until later is problematic.

It's about being creative. It's about understanding the marketplace in a way that your competitors don't and asking the right questions and seeking the right answers. So, my advice to my client is consistently to say, "Let's work together as a team. Let us find both the creative solutions and the mechanisms by which we can have effect on the marketplace that other people aren't seeing and use the public process to your advantage because it isn't always a disadvantage. So, take the broader viewpoint and don't limit your opportunities by what you're seeing in the standard marketplace."

**FELDMAN:** I basically tell people that they really should communicate effectively about what they want. Be credible because we see in the closing of transactions the competition, and participants need to act in good faith to prove that they're the real deal. And then I tell them to listen because there is a need for flexibility as you go through the process, even though everybody is trying to go at warp speed and you want to get a favorable result.

**WHITE:** Mine would be don't lose sight of the fundamentals. There is still room for creativity. There's plenty of room for variations in our decision-making, but we can't lose sight of the basic fundamentals of real estate lending. That'll probably keep us out of major trouble in the downturns. It is easy to get caught up in the super-low cap rates that we're seeing now, and sometimes it is necessary to make aggressive lending decisions to keep up with our competition. Sometimes the best real estate decision may support that thinking. But we have to keep the fundamentals in mind and know what kind of borrower we're working with, what kind of property, and how the market and the economy are performing. We ought to be fine if we can keep those things in mind when we make our decisions.

**HUGHES:** Congestion is a sad reality of most places people want to develop. However, congestion has forced us to focus on alternatives to traditional sprawl development, which are a better use of the land and infrastructure.

As lawyers, we are using and adapting these issues in promoting projects that have the right characteristics and opposing those that promote congestion and sprawl. Requirements are increasing on developers to demonstrate by greater amounts of reporting and analysis that they have quantified, assessed and addressed congestion in their project design and mitigations.

**CREJ:** What's most compelling about this conversation is the fact that you can hear the echoes of all the real estate practitioners expressed in your points of view. It just reinforces how significant attorneys are to making sure deals get done. 📌