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Recent REIT Initial Public Offerings

As a result of the financial crisis and the dislocation of the credit markets, is there renewed interest in newly formed REITs?

In the last 18 months, there have been 15 REIT IPOs: nine in 2009 and six through June of 2010. The six REIT IPOs this year have raised over $1.1 billion. The REIT IPO pipeline for the remainder of 2010 indicates increased demand.[1] The increased demand for REIT IPOs is justified by both liquidity and other structural benefits provided by REITs.

Some investors have grown frustrated with open-end private funds that have far less liquidity than REITs. After all, the liquidity of most private fund vehicles is only as good as the liquidity of the underlying properties. The financial crisis showed that certain investors were not prepared for the risk of illiquidity of private real estate funds with high direct property investments. In early 2009, investor redemption requests spiked and forced the majority of open-end private funds to halt redemptions. In contrast, liquidity in the REIT market has grown significantly and while liquidity in the private market slowed during the recent financial crisis, significant liquidity for REITs was sustained.[2] This is attractive to investors.

Selling individual properties has also proved difficult and inefficient. Scarcity of financing, troubled assets and a higher probability of deals not going through to closing has led to yet more frustration. Contributing properties to a new REIT is a sales strategy being discussed more and more.

Despite increased liquidity and stronger historic performance, REITs currently account for only 5% of U.S. corporate and public pension real estate allocations, amounting to roughly $12 billion of the $252 billion such pensions invest in real estate.[3] Cohen and Steers concludes that as a result of the financial crisis, many institutional investors may change their real estate allocations and increase their investments in listed real estate over time.[4] And Sellers may conclude that a REIT IPO may be their best way to unload properties and obtain new capital.

But, not so fast. Welsh Property Trust recently delayed its IPO; it originally planned to raise more than $300 million which would have ranked it as the largest REIT IPO so far in 2010.[5] No REIT IPOs were completed in May (more than 30 companies worldwide shelved their IPOs in May and June), which is certainly a reflection of broader market volatility. Given market concerns over Europe's debt crisis, such market conditions create another level of uncertainty that makes an IPO even riskier.[6] Certainly, no one relishes having to pay the costs of a failed IPO or the stigma that can attach by reason of that failure.

The U.S. IPO market, however, may be recovering. There are some recent signs of renewed optimism. Hudson Pacific Properties, an office REIT with properties in California, raised $218 million in late June.[7] The share price of $17 was within Hudson Pacific's proposed price range of $17 to $19.

So, there are valid reasons for more REIT IPOs during these tough times and beyond. But market concerns are having a strong chilling affect on the decisions to go that route. Stay tuned.■

1. See Clay Risher, *Real Estate Offered Up,* Real Estate Investment Today, May/June 2010, *available at* http://www.reit-digital.com/reit/20100506#.
2. See Joseph Harvey, *The Truth About Real Estate Allocations,* Cohen & Steers, May 2010, *available at* http://www.reit.com/Portals/0/PDF/CohenSteersReport.pdf.
3. See id. at 10.
4. See id. at 11.
5. See Burl Gilyard, *REIT Place, Wrong Time? Welsh IPO On Hold,* Finance & Commerce, June 5, 2010, *available at* http://www.finance-commerce.com/article.cfm/2010/06/05/REIT-place-wrong-time-Welsh-IPO-on-hold.
6. See Inyoung Hwang & Michael Tsang, *IPOs Derailed by Market Plunge as Americold, Ryerson Shelve Initial Offers,* Bloomberg News, May 7, 2010, available at http://preview.bloomberg.com/news/2010-05-07/ipos_derailed-by-market-plunge-as-americold-ryerson-shelve-initial-offers.html.
7. See Kristin Sholer and Inyoung Hwang, *Hudson Pacific Raises $218 Million in IPO of Office REIT; Shares Advance,* Bloomberg News, June 24, 2010, available at http://www.bloomberg.com/news/print/2010-06-24/hudson-pacific-raises-218-million-in-reit-ipo-at-bottom-of-price-range.html.

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Commercial Subleases: Coping with the Subordination Risk

The decline in the commercial rental market in the recent economic downturn has not been without its silver lining. Some businesses—newly emerging or having successfully weathered the economic storm—are eager to implement long-term growth plans by taking advantage of the low rents and high volume of available space. As these businesses begin to explore the current leasing market, they may be intrigued by attractive space being offered to be sublet by their current occupants who can no longer carry their lease obligations or are otherwise trying to unload excess space. Should businesses shy away from subleases in favor of a direct lease with a building owner?

Subleases are initially appealing since sublease rental rates are traditionally cheaper than direct lease rates. However, prospective subtenants should be aware that these lower rates reflect legal, logistical and operational disadvantages inherent in the sublease arrangement. While a full analysis of these risks should be performed by the subtenant's attorneys and real estate consultants on a case-by-case basis, this article will address one fundamental risk common to all subleases, and suggest how a prudent subtenant can attempt to alleviate some of that risk.

As a matter of contract law, subleases are "subject and subordinate" to the underlying lease. In essence, this means that a sublease remains in effect only for so long as the underlying lease remains in effect. If the term of the underlying lease expires, or is cancelled on account of the tenant's default or for any other reason, the sublease will automatically terminate. The subtenant will be required to surrender possession of its premises and, depending on the terms of its sublease, may be required to restore the premises to the condition they are required to be returned to the landlord upon the expiration of the term.

While there is no way to completely mitigate against this subordination risk, the subtenant can take some measures that afford some partial protection. Although it is always prudent to perform due diligence on a party with whom you are about to enter into a contract, it is especially important to do so before entering into a sublease. Due to the subordination risk a subtenant can lose its entire estate if its sublandlord fails to perform under the lease, and a subtenant needs to be confident that its sublandlord is in a position, financially and operationally, to perform all of its obligations under the lease. If the sublease rent is not sufficient to support the financial obligations under the lease on its own, and/or the sublandlord's business is showing signs of vulnerability, the subtenant should be aware that its subleasehold estate may be precarious.

If the underlying lease is cancelled, and such cancellation is due to a default by the sublandlord, the subtenant should ask that the sublandlord fully indemnify it for any losses or damages it incurs on account of such cancellation. Of course, this indemnity is only as valuable as the credit supporting it; if the underlying lease was cancelled on account of a default by the tenant, there is probably no real credit to rely on. Therefore, a subtenant should also consider requesting a notice and cure period during which the overlandlord will agree to notify the subtenant of any defaults by the sublandlord, and to accept the subtenant's performance of the sublandlord's lease obligations. This would allow the subtenant to control its ability to remain in the premises. To avoid having to chase the sublandlord to recoup the expenses it incurs to cure the default under the underlying lease, the subtenant should request the right to offset the amount it expended from the sublease rent.

In certain specific circumstances, it may be appropriate for the subtenant to request a recognition agreement from the overlandlord. Protection under a recognition from an overlandlord works in a similar manner as a non-disturbance agreement from a mortgagee. A recognition agreement will provide that if the underlying lease is cancelled due to the sublandlord's defaults, the overlandlord will "recognize and not disturb" the subtenant's possession of the premises provided that the subtenant is not in default of its sublease. One crucial difference between the non-disturbance agreement granted by a mortgagee, and a recognition agreement granted by an overlandlord, is that in the latter case, the parties need to determine whether the recognition agreement will be based on the terms (including the rent) set forth in the sublease or, as the overlandlord will likely prefer, on the terms of the underlying lease.

Overlandlords are understandably very reluctant to provide a recognition agreement, and typically entertain the subtenant's request only under very specific circumstances. Obviously, the rental rate upon which the recognition agreement will be based has to be consistent with present market conditions. Other criteria that will be taken into account is the creditworthiness and business reputation of the subtenant, whether it is making a significant investment in the premises, and whether the sublease is for a sufficient term. Depending on the dynamics of the overlandlord's relationship with the tenant (i.e., perhaps the tenant has additional space in the building and the landlord has an incentive to keep the tenant happy), the subtenant may be able to solicit the tenant to act as its advocate.

Note that even if an overlandlord were to provide a recognition agreement, such recognition agreement is not completely protective as it has its limitations. Specifically, an overlandlord will not want to assume liabilities for pre-existing conditions, including existing defaults, rent concessions or work allowances, and will likely require additional notice and cure periods before a subtenant can exercise its remedies against the landlord under the sublease. Nevertheless, these limitations are often negotiated and the benefits of the recognition agreement still outweigh the burdens herein described.

Businesses scouring the leasing market should not instinctively resist otherwise appealing sublease deals. They should understand the subordination risk inherent in their subleases, but also seek ways to mitigate its consequences. ■

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Solar Rooftop Generation: A Primer For Real Estate Owners And Developers

The electricity industry's movement toward renewable energy development presents a unique opportunity for owners and developers of large-scale real property (e.g., warehouses and distribution centers). Such owners are exploring the feasibility of reducing energy costs and "going green" through the installation of on-site renewable (solar) generation. One exciting and growing application of renewable electric generation entails the installation of rooftop solar, photovoltaic ("PV") panels to convert the sun's energy directly into electricity. The following is a primer on what real estate owners and developers need to consider before embarking on the installation of a rooftop PV system.

Technical Feasibility/Permitting

Whether a PV rooftop system is feasible depends on a number of factors, including the age and condition of the structure's roof. Generally, roofs that are five years old or younger may be sufficiently stable to sustain the PV equipment. As a general rule, approximately 100,000 square feet of roof space is required for a 1 MW solar array. Finally, an owner should review local ordinances to determine if there are any restrictions on, or special permits required for, such rooftop structures.

The structural integrity of the roof will typically be determined by an independent engineering inspection, and the existence of a warranty from the installer of the roof, particularly a long-term warranty from a financially viable party, will facilitate the financing and construction of the solar facility. In the absence of a warranty, building owners may be able to satisfy legitimate structural concerns of the contractor (and the contractor's lender) through the procurement of a warranty, which can be expensive, or through the establishment of a robust preventative maintenance plan.

In addition to municipal permitting matters that a building owner should address, there are electric-related permitting and approval steps that the building owner (and/or the contractor building the solar facility) will need to satisfy, including: (a) municipal electric codes; and (b) utility electric interconnection requirements. The latter requirement will be particularly relevant if the building owner elects to participate in net metering, as described below.

Economics

If a rooftop solar system is technically feasible, a developer would then need to consider the economics of such a system. In a typical model, the developer would lease its rooftop space to a contractor that would construct, own, operate and maintain the solar system. The contractor would enter into a long-term power purchase agreement ("PPA") with the real property owner under which the contractor would sell electricity to the owner at a rate representing a discount from the otherwise applicable utility tariff. The length of the PPA would depend, in part, on the useful life of the solar system, which could be in excess of 15 years.

The contractor finances the construction of the solar system through the revenue streams represented by the PPA sales to the property owner and the sale of renewable energy certificates ("RECs"), which are tangible rights related to the beneficial environmental attributes associated with generating power from a renewable resource. A single REC represents one megawatt-hour of electricity generated from a renewable resource. RECs can be sold separately from the power generated to create them, and there are several markets (in various states) in which RECs may be traded. For example, New Jersey has a particularly active market for the trading of solar RECs.

While the chief economic benefit for the owner associated with the rooftop PV system is the stream of energy savings associated with the PPA, an owner may wish to negotiate with the contractor for a share in the revenue attributable to the sale of RECs. Additionally, a building owner could be eligible to participate in the "net metering" program of its local utility. Under such a program, which technically does not involve a "sale" of electricity, the owner could receive monetary billing credit or payment for excess electricity produced by the solar facility at a rate equal to the utility standard retail rate for sales to the owner. Contractors may negotiate for a portion of this economic benefit to facilitate the financing of the solar facility.

Regulatory

Because a rooftop solar cannot produce electricity in every hour, an owner needs to consider the rate it will pay for electric service obtained from its local utility (or an alternative supplier) when its rooftop system is not producing power.

(Rooftop facilities produce power on average for six to eight hours per day.) Some utilities require a customer with "on-site generation" to take electric service under a "standby" service tariff with rates that may differ from the otherwise applicable tariff rates paid by the owner. This differential needs to be factored into the economic analysis of the solar rooftop generation.

With a contractor assigned the responsibility of owning, operating and maintaining the rooftop system, there are minimal regulatory considerations for the property owner under state and Federal laws regulating utilities and the services they provide. While the contractor may be subject to limited regulation in certain jurisdictions, the owner, who is a retail purchaser of electricity under the PPA, will be subject to no public utility regulation and will need to consider, as noted above, the terms of service for those hours when its rooftop array is not producing. In addition to net metering, if an owner or developer wishes to consider the sale of excess power produced by the rooftop PV system to either the local utility (e.g., a direct wholesale of electricity to a utility), or a customer located near the owner's site (a retail sale of power), additional regulatory, technical and economic considerations will need to be examined.

Access/Subordination

One of the primary documents that a building owner will need to negotiate with the solar-facility contractor, in addition to the PPA, is the roof lease. This agreement will confer several important rights on the contractor, including the right of access to the building owner's roof for purposes of constructing, operating and maintaining the solar facility. Contractors (and their lenders) will be concerned with having access rights to the roof free from interference by building tenants or entities holding any mortgage on the building. Additionally, contractor lenders may request that building lienholders subordinate their rights to the lender's security interest/lien so that the lender's rights to access the roof and the solar facility are protected, for example, should the lienholder foreclose.

Renewable energy, particular rooftop solar, may offer an attractive opportunity for owners and developers of real property to lower energy costs and establish a market reputation for responsible energy usage. Rooftop solar installations are gaining in applications across the country, particularly in California, Pennsylvania, Texas and New Jersey. With careful consideration of technical, economic and regulatory factors, a real property owner or developer may find that a rooftop PV installation is a feasible energy solution. ■

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"Bad Boy" Guaranties and Protecting Yourself from Acts of Others

A typical mortgage loan requires the borrower and/or its principals to execute a "bad boy guaranty" (a/k/a recourse carve out guaranty), which provides for personal liability against the borrower and principals of borrower upon the occurrence of certain enumerated bad acts committed by the borrower or its principals. Where the transaction involves mezzanine debt, it is essential that the mortgage lender and the borrower and/or guarantors take certain steps to ensure that the bad acts of a foreclosing mezzanine lender do not trigger this personal liability.

If triggered by enumerated bad acts, bad boy guarantees require the borrower and/or guarantor to be personally liable for damages to the lender, or alternatively, converts an otherwise non-recourse loan into a full-recourse loan as against the borrower or guarantor. In either result, lenders will have the right to seek significant personal liability against the borrower and/or guarantors, so it is essential that borrowers and/or guarantors have complete control over the potential triggering acts.

In the last 15 years there have only been six legal challenges to the enforceability of bad boy guaranties. This lack of challenges indicates that these guaranties have largely accomplished their goal of forcing borrower and guarantors to stay away from the typical bad boy acts enumerated in these guaranties, such as waste, fraud, misappropriation, bankruptcy, violation of SPE covenants or incurring subordinate debt without lender's consent. Furthermore, all of these recent challenges have resulted in the enforcement by the courts of the bad boy guaranties in question. By way of example, recently, in the *Extended Stay of America* Chapter 11 bankruptcy proceeding,[1] guarantor David Lichtenstein was held jointly and severally liable with his company, Lightstone Capital, for a $100 million guarantee following the company's bankruptcy filing. The court enforced the clause and the investors of the senior lender subsequently indemnified him.

Nonetheless, these guaranties can have the unintended consequence of penalizing guarantors for improper acts of third parties outside of their control. After a mezzanine takeover of a guarantors' equity interests in the borrower, the new equity owner can create personal liability for the borrower and/or guarantor without any repercussions for itself. Since the guarantor has in most cases lost its managerial and ownership interest in the borrower following a foreclosure, the guaranty has lost its purpose as a mechanism to constrain borrower's activity.

By way of example, the mezzanine lender, with its controlling equity interest, can, without the input of the guarantor either: 1) put the borrower into bankruptcy thereby triggering the guaranty against the guarantor and impeding the primary lender's foreclosure; or 2) use bankruptcy as a threat in its negotiations with the mortgage lender. Neither the mortgage lender nor guarantor benefit from this scenario. Accordingly, it is essential that the mortgage lender and borrower protect themselves from the unintended consequences of these bad boy guaranties where mezzanine debt is to be in place.

Defense Mechanisms

Mortgage lenders should be aware that a bad boy guaranty ceases to be effective as a mechanism of behavioral control when the party directing a borrower's actions will feel no repercussions from the violation of the covenant. Thus, mortgage lenders should require a poison pill of sorts to prevent the mezzanine lender from triggering these clauses. Lender's initial agreement with borrower (or any inter-creditor agreement with the mezzanine lender) should stipulate that any mezzanine lender (or other entity approved by mortgage lender) must sign an agreement that stipulates upon potential foreclosure of equity interests, that such mezzanine lender must accept and assume the same guaranty provisions as the original guarantor. If borrower breaches this requirement by obtaining secondary financing without this provision, the bad boy clause could be immediately triggered. In this way, any mezzanine lender would be forced to assume the guaranty if they control borrower's equity interest which would benefit both the mortgage lender and the guarantor.

Borrowers, however, may severely balk at this requirement as it could greatly limit their ability to obtain mezzanine financing. Borrower/guarantors simply want their guaranty obligations to terminate when they lose managerial power. Lenders may be skittish about such an immediate termination, because foreclosing mezzanine lenders would still retain the power to put the company into bankruptcy and/or violate the provisions of the bad boy guaranty without repercussions. So, rather than seeking a termination of the guaranty, as an alternative middle ground, guarantors should require the mezzanine lender and/or a credit entity affiliated with the mezzanine lender to indemnify borrower if the bad boy guaranty is triggered by the acts of mezzanine lender. This transfers the liability under the guaranty to the mezzanine lender, and creates an inducement for the mezzanine lender to not trigger the guaranty.

The strategy you seek depends on your position. If lenders do not protect themselves, they have entrusted the borrower to shift the guaranty to the mezzanine lender. Regardless of lender strategies, the borrower/guarantor should require an indemnification from the mezzanine lender.

All of the above referenced strategies have the effect of transferring the liability under the guaranty to the mezzanine lender upon foreclosure by the mezzanine lender on the equity interests of the borrower. Thus, these practices should not significantly change the cost of mortgage lending because both parties benefit. However, the foregoing strategies may well result in an increase in pricing for the mezzanine financing.

Ultimately, mortgage lenders will continue to ask for bad boy guaranties triggered by bankruptcy and other bad acts. As mezzanine lending becomes more available, mortgage lenders and borrowers have an opportunity to assert new practices which seek to limit mezzanine lender's leverage in a foreclosure situation.■

1. In re Extended Stay, Inc., 418 B.R. 49 (Bankr. S.D.N.Y. 2009).

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