

Overview: Fundamentals of Real Estate

Chapter 5: Legal Dimensions of Real Estate

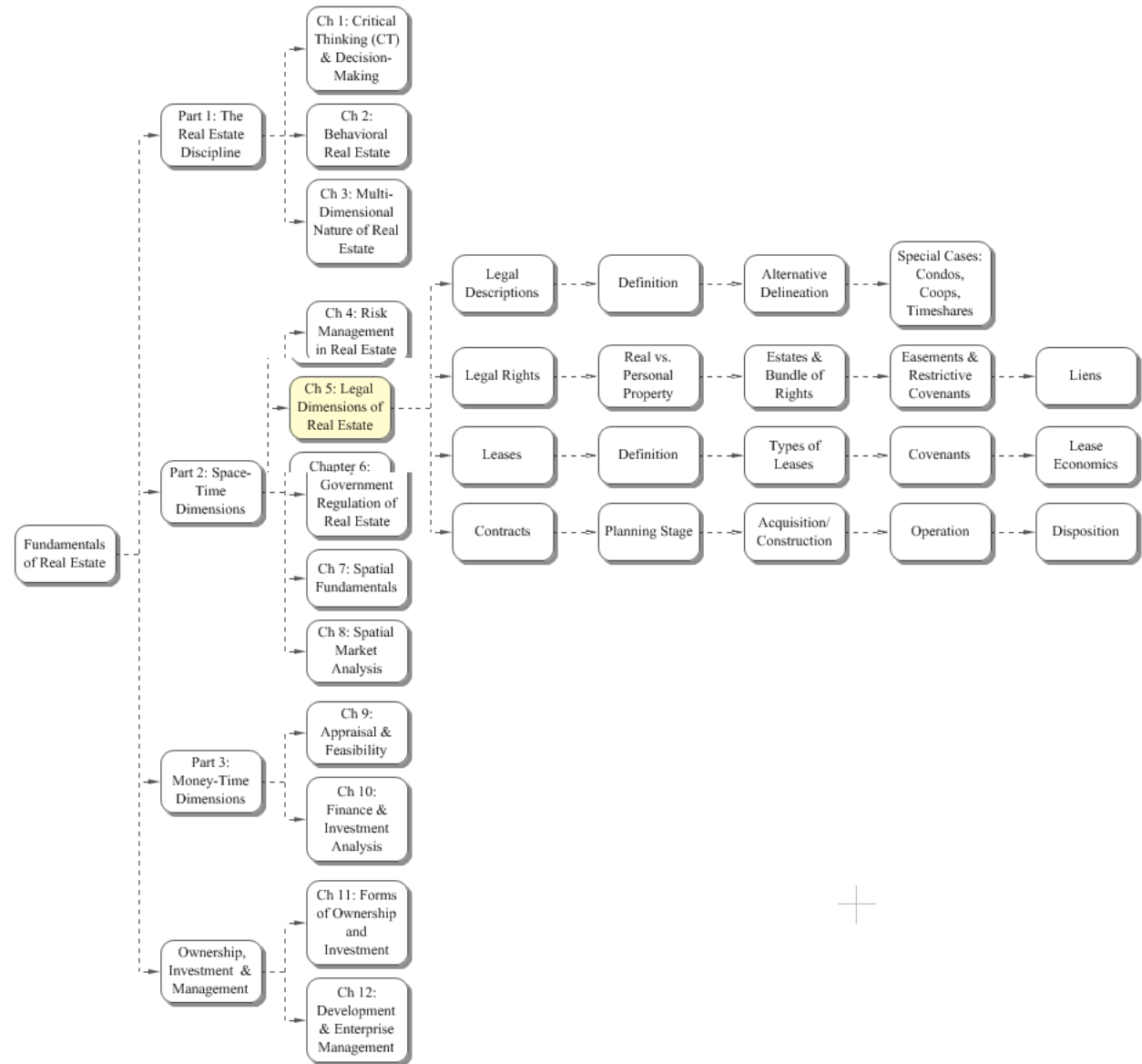


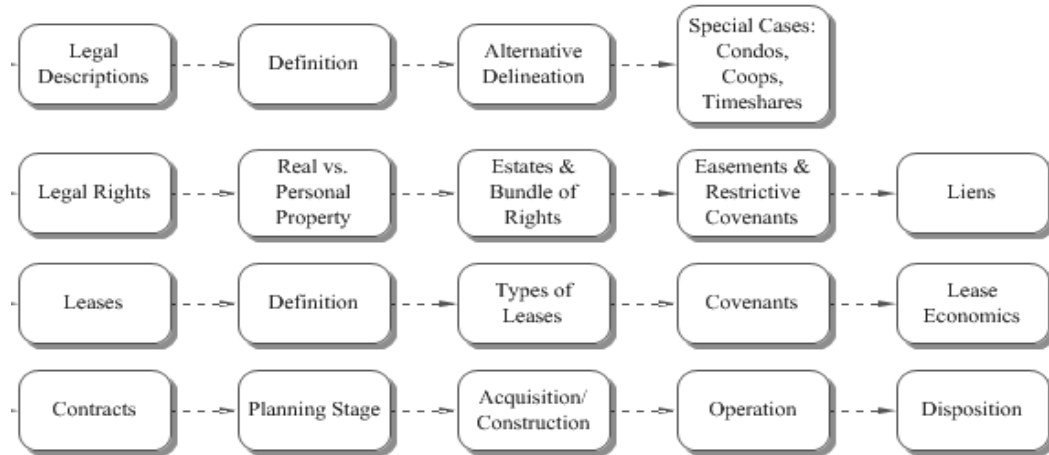
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Chapter 5: Preview



Overview

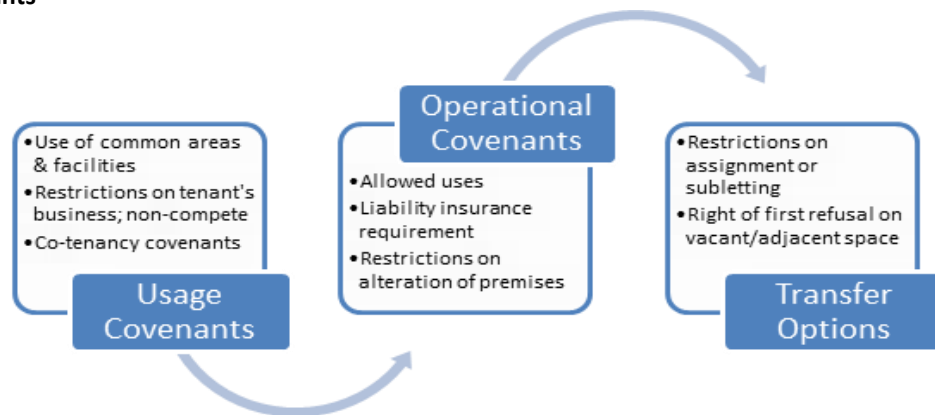
This chapter provides an overview of the legal dimensions of real estate. It begins with legal descriptions which provide unambiguous and enduring delineations of the boundaries of individual parcels of land. It explores alternative ways of delineating boundaries and discusses special cases including condos and timeshares. The discussion explores real property rights and estates, both freehold and leasehold. It introduces some of the private constraints on land use including easements, restrictive covenants and liens.

Given their critical role in stabilizing “assumptions” made about commercial property investments, leases are presented as a particular area of interest from a legal perspective. The major types of leases and covenants used to manage risk are reviewed along with a brief introduction to lease economics. The chapter closes with a review of the myriad real estate contracts that may be involved over the life cycle of a property ranging from planning to disposition.

What you will learn in Chapter 4

- The importance of legal descriptions and how they are developed.
- Descriptions for special types of real estate.
- The difference between real property and personal property and tests for fixtures.
- The “bundle of rights” and types of estates in real estate.
- Private market restrictions on use including easements & restrictive covenants.
- How liens are created and their impacts on ownership.
- The role of leases in commercial properties.
- The major types of leases (e.g., Gross-NNN).
- The major covenants in leases and the roles they play.
- A basic understanding of lease economics.
- The range of contracts and agreements across the real estate life cycle.

Selected Lease Covenants



Legal Dimensions of Real Estate

Real estate is a complex asset class in which ownership rights can be partitioned and sold off, leaving a residual bundle of rights that is far different from what one might assume for other asset classes. Thus, it is critically important that real estate players understand the legal dimension of real estate, with particular attention to private property rights and how those rights are bought and sold in the market. The starting point of this fundamental analysis is the delineation of individual properties to make sure they are clearly and unambiguously defined. Once defined, it is possible to explore the rights bestowed on owners of that property along with other claims that may impinge on those rights. It is also important to explore the various forms of ownership and/or control that determine who enjoys those rights and how they may be shared or transferred. Finally, to get a better appreciation for the legal dimensions of real estate, it is important to explore the myriad legal contracts that are involved in the planning, acquisition or development, operation and disposition of real estate assets.

Legal Definitions of Real Estate

Real Property vs. Personal Property

- Real property: Rights in land and its permanent structures
 - Surface of the earth and improvements
 - Air, up to reserved air space or tallest structure
 - Subsurface as technology allows: Minerals, oil, gas,
- Personal property: All other property
 - Personal and household goods
 - Intellectual property, music
- Fixtures
 - Real property that formerly was personal property
 - Tests
 - Manner of attachment
 - Character of the article and manner of adaptation
 - Intention of the parties (dominant rule)
 - Not included: trade, agricultural & domestic fixtures

There are two basic types of property: real property and personal property. The term “land” or real property is something of a misnomer. That is, it refers to the surface as well as everything that is attached to it by nature or hand of man. Fixtures are a special case and in some circumstances are considered real property while in others they are considered personal property. The determination of whether an object attached to the land is real property or personal property depends on the method of attachment and the intent of the parties.

Exhibit 5- 1

In addition to the surface rights, real property includes everything above the surface as well as under the surface. Thus, ownership of land typically contains rights that stem to the center of the earth as well as the pyramid formed by its boundaries emanating upward. These rights are typically transferred with the ownership of the land even if not explicitly mentioned. However, these rights can be split off, as in the case of a sale of mineral rights but retention of surface rights or retention of mineral rights but sale of surface rights. Similarly, an owner can opt to sell portions of the air rights above the surface, or can transfer the surface rights and retain the air rights for future development. This ability to partition land both horizontally and vertically creates the opportunity to develop condominiums as well

Legal Definition of Real Estate

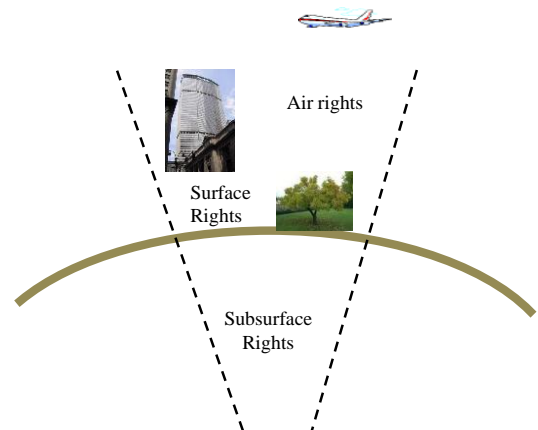


Exhibit 5- 2

as erect buildings and other structures above surface uses, allowing a purchaser to obtain control of the delineated cubage regardless of who owns the surface or subsurface rights.

Legal Descriptions

One of the more obvious “unique” elements of real estate is the fact that it is fixed in location relative to the earth. This locational anchor becomes an important element as it establishes a reference point that can be used to describe a site or property. The ability to unambiguously define a property is critical to the industry as it allows the market to know who owns what; a dramatic improvement over the caveman’s days when his turf had to be constantly delineated and defended. In the modern era, the unambiguous delineation of properties can still be challenging since landform patterns that can be changed by shifting rivers and coastal boundaries. Also, legal descriptions must span regions with dramatic changes in topographical patterns ranging from valleys to mountain ranges. Finally, manmade features can be changed and roads can be rerouted. Despite these changes, real estate remains fixed in location and must be delineated by adequate spatial boundaries to make to stand the test of time.

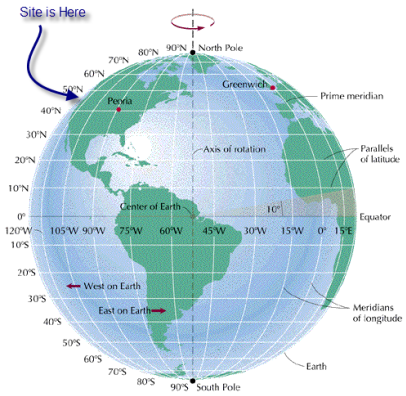


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Types and Techniques for Legal Descriptions

There are a number of methods for generating legal descriptions with the appropriate choice depending on the location of the real estate, its shape and what jurisdiction it falls in. Some of the common options for delineating space include “metes & bounds” which is based on bearings and distance; Government Survey which divides the country into a series of tiers and ranges that are broken down into township/section/sub-section; and, plats which layout subdivision blocks and lot. Each of the systems has its limitations and challenges. For example, the metes and bounds

technique can require complex geometrical analysis to deal with irregular land shapes and uneven terrain. On the other hand, the Government Survey method is based on a rectangular grid and doesn’t lend itself to irregular shapes. To address some of these issues, land surveyors are relying on a number of technological innovations including Global Positioning Systems (GPS) which can provide pinpoint latitude and longitude locations of markers, Geographic Information Systems (GIS) which can be used to overlay multiple layers of data, and Remote Sensing which can render accurate 3-dimensional delineations of extreme topographic areas. Regardless of how the boundaries of a site are delineated, the output is known as a legal description. This description is relied on to support transactions and becomes attached to the

- Metes and Bounds
- Government Rectangular System
- Subdivision: Lot and Block
- Property Tax ID
- Technological Innovations:
 - Global Positioning Systems (GPS)
 - Geographic Information Systems (GIS)

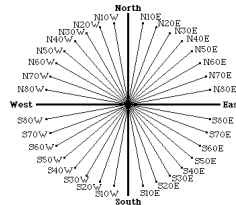
Exhibit 5- 4

property and transfers along with it. The exception is in a partial sale or subdivision of property (also known as short-platting) which creates multiple parcels out of a single parcel. In such cases, new legal descriptions are created to identify the newly created individual parcels as well as the residual part of the original property.

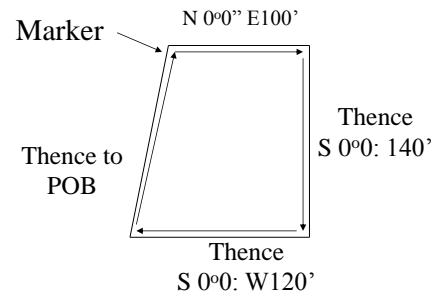
Alternative Approaches to Legal Descriptions

Metes and Bounds

One of the earliest methods for delineating land boundaries is the metes and bounds systems. In essence, the system creates a set of vectors or geometric shapes that enfold some area. Each vector has a fixed length and draws its bearings from a north/south line, indicating whether it travels east or west and if so, by how many



Delineation by Metes and Bounds



degrees. Once it hits the end of the line, a new vector is created along with a new bearing. One of the critical elements of a metes and bounds system is the identification of a unique starting point. Typically this was some marker (i.e., big rock, river bank or road intersection) although it can now be a precise latitude/longitude. Starting with that marker, the surveyor indicates the direction and distance for the initial vector. Once the line segment ends, the description starts from that point and notes the degrees to the next vector is from the north/south line, as well as whether the bearing is east or west, as well as the distance it travels. This process is repeated until the pointer hits the point where the final bearing simply returns to the Point of Beginning (POB).

Exhibit 5- 5

Public Land Survey System (PLSS)

Original Territory for PLSS



Exhibit 5- 6

The Public Land Survey System (PLSS) was developed after the Revolutionary War to map out the newly acquired land outside of the original 13 colonies. At the time, Texas was not part of US territory and thus was not included. The cadastral survey of land boundaries was created under Congressional mandate in 1785 to delineate parcels of public land which would be suitable for disposal by the Government. Briefly, the system rectangular grids that delineates Townships which consist of 36 miles square (i.e., note 6 x 6 miles which is 36 square miles). The grid system is based on a series of 37 vertical lines known as the Principal Meridians that travel north and south and a system of base lines that run east and west. To adjust for the curvature of the earth, correction lines are set up every 24 miles from the base lines

creating a set of districts. These districts are broken into a series of townships that are designated as tiers or rows running from the base lines and as ranges running east or west of the respective Meridian lines.

Public Land Survey System

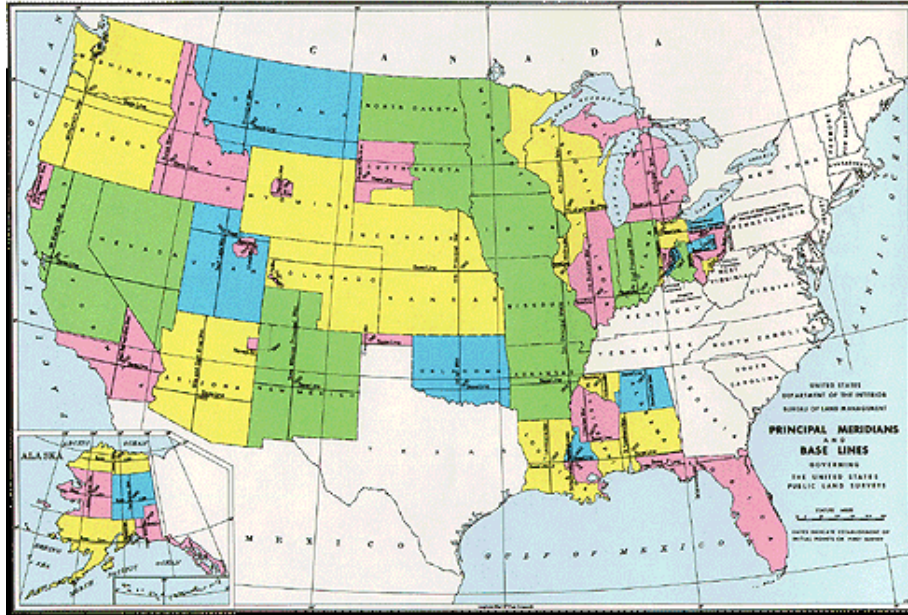
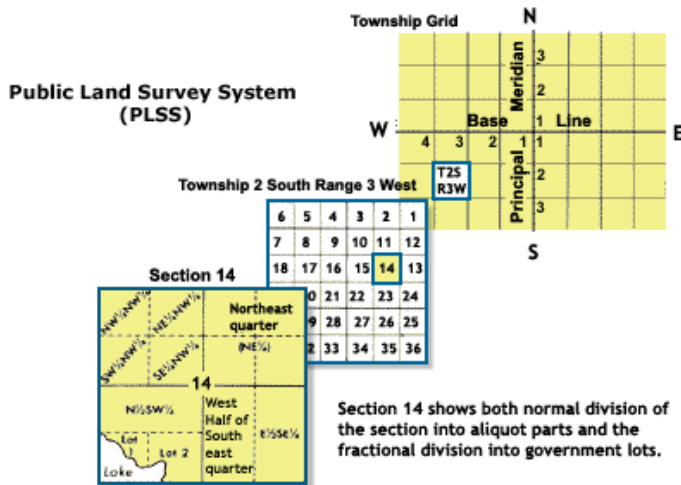


Exhibit 5- 7

Source: http://www.nationalatlas.gov/articles/boundaries/a_plss.html

Public Land Survey System Detail



Using the government survey system, a complete legal description includes the Principle Meridian Name, the Township and Range designations, and the Section number and sub-section area. For example, if the Section 14 in Exhibit 5-8 is located in, the description would be Township 2South, Range 3West located East of the Principle Meridian, Section 14. Since each Section is 640 acres (i.e., 1 mile square). These sections are broken into 4 quadrants of 160 acres (NE, SE, NW & SW). From there, each quarter of the quadrants is 40 acres explaining the typical 40 acre farm. So, the description of a farm could be the T2S, R3W, E of Principle Meridian, S14, NE ¼ of NE ¼ for some 40 acres.

Exhibit 5- 8

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Subdivision Plat: Block and Lot

In urban areas, land developers have filed subdivision plats which combine various geographies into a common base area. Using a set of block and lot designations, the individual parcels are mapped out using a system of metes and bounds to accommodate irregular shapes that are typical in many subdivisions. Once the subdivision plat has been approved, the exact location and shape of a parcel is defined by the Block and Lot within this larger geographic area. While traditionally related to residential properties, subdivisions can be plotted for industrial parks, office parks and mixed-use projects.

Subdivision Block and Lot

Subdivision Block and Lot

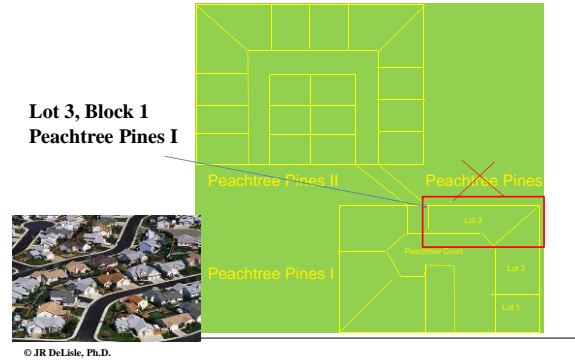


Exhibit 5- 9

Tax Identification Numbers

Parcel ID Number – Tax Records

Assessor Real Property Records:			
Taxpayer	TRINITY 43RD AVE LLC	Parcel Number	1145000070
Tax Year	2007	Account Number	114500007009
Tax Status	TAXABLE	Levy Code	0010
		Taxable Value Reason	NONE OR UNKNOWN
Appraised Land Value	\$1,595,100	Appraised Improvement Value	\$1,000
Taxable Land Value	\$1,595,100	Taxable Improvement Value	\$1,000

Assessor Property Sales Records:			
Tip: Use the Recorder's Office Excise Tax Affidavits Report to see more sales records details			
Sale Date	11/15/2004	Sale Price	\$1,650,000
Seller Name	HO BONGH-HEE JOO		
Buyer Name	TRINITY 43RD AVE LLC		
Sale Date	6/29/1984	Sale Price	\$800,000

Exhibit 5- 10

Property Tax ID Numbers

In the U.S., property taxes are based on an ad valorem (i.e., at value) system which is predicated on an accurate legal description. As such, unique tax identification numbers are assigned to all privately held land parcels are assigned by local property tax officials. These Tax ID numbers become part of the public record, creating a unique numbering system that is used to record building permits, property tax assessments, liens and other

activities over time. While the assessment

records will provide some detailed information on the site and improvements, it should not be relied on as a legal description since it serves a different purpose and may not satisfy the requirements for unique spatial delineation required in the ownership and transfer of property interests. That said, property tax ID numbers can open the gates to wealth of information about a property and its surrounding environs.

GPS and Global Legal Descriptions

The advent of Global Positioning Systems (GPS) and Geographic Information Systems (GIS) has revolutionized the specification of legal descriptions, especially for complex parcels with boundaries that follow irregular patterns. In essence, under both systems coordinates of latitude and longitude are used to pinpoint turning points and boundary lines. The advantage of these approaches over reliance on predetermined geographic shapes is the ability to uniquely and unambiguously specify the boundaries of properties regardless of where they are located in the world, creating a globally consistent system.

GPS-Based Delineation of Space

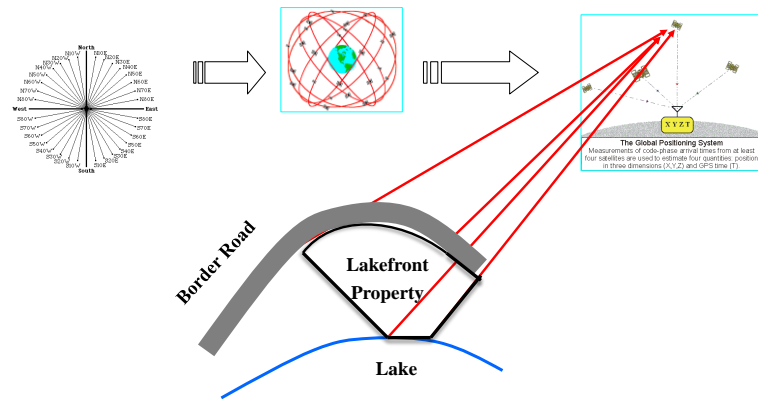


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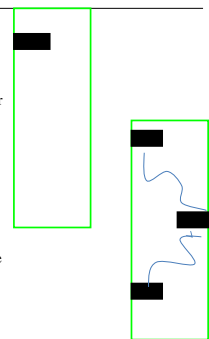
Special Purpose Legal Definitions

In addition to the traditional legal descriptions of land, several special cases have been developed. These include definitions of condominiums, cooperatives and timeshares. A condominium unit is defined the same as a parcel of land, with the addition of a third dimensional component that delineates a cube located above the surface of the earth. In addition to the physical cube or unit, the condominium owner may own a pro-rata share of the common areas of the building as well as the site. A cooperative unit is different from a condominium in the sense that a corporation owns the real estate, and the coop owner receives a right to use a certain portion of the premises but not a specific unit. As such, upon sale the next owner may not have rights to the same unit as the prior owner but will be entitled to a comparable unit. A timeshare differs from a condominium in the sense that the ownership right to a

Condominiums vs. Cooperatives

Condominium vs. Cooperative

- Condominium
 - Combines single ownership and tenancy in common
 - Condominium declaration, bylaws define owner rights
 - Share of all obligations
 - Restrictions on sale or rental
 - Methods of altering bylaws
- Cooperative
 - Corporation owns property
 - Each owner holds shares and a proprietary lease (no term)
 - Cannot mortgage individual interests
 - Owner's mutually liable for any specific liens



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Exhibit 5- 12

particular unit is limited to a finite temporal frame (e.g., the 2nd week of January) each year. The rest of the year, the rights belong to other owners.

Legal Rights

Bundle of Rights

The interests in real estate associated with a particular parcel can be considered a “bundle of rights.” This bundle includes a number of interests ranging from the exclusive right to use and enjoy the property. However, the rights are not absolute, but are subject to government regulations and other claims. Depending on the nature of the interests, the package of rights can be unbundled and transferred or pledged to collateralize a mortgage or some other financial obligation.

Rights in Real Estate

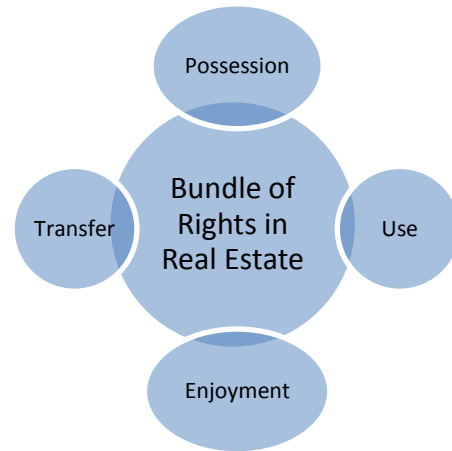


Exhibit 5- 13

Possessory Interests

	Estates		
	Freeholds		Leaseholds
	Fee Simple	Life Estate	
Exclusion			
Use and Enjoyment			
Transfer		Already Conveyed as Remainder Estate	Reverts to Landlord

Exhibit 5- 14

Estates

The rights can be subdivided into two categories; possessory interests which deal with direct usage, and non-possessory interests which deal with non-ownership positions of a temporary nature. The most complete interests in real estate are freehold estates. Freehold estates may be subdivided into fee simple estates or life estates. Fee simple estates are the most comprehensive, providing the right to exclusion, use and enjoyment and transfer. As the name might imply, the life estate has the same bundle with the exception of the right to transfer. Upon termination, the right reverts to the seller as a remainder estate.

Leasehold Estates and Leases

Leaseholds estates are another form of possessory interest although the rights that are conveyed are temporary in nature and ultimately revert to the owner or landlord. In general, leases create temporary usage rights. The duration of these rights is established by contractual agreement between an owner (i.e., lessor) and the tenant (i.e., lessee). Unless renewed or transferred, the leasehold rights transfer back to the owner upon expiration of the lease.

Non-Possessory Interests

Easements

Easements are a non-exclusionary forms of real estate rights to use or traverse a portion of a site; it does not convey any right to develop and/or customize the space to meet a particular need. There are two types of easements: easement appurtenant, and easements in gross. Briefly, easements appurtenant are granted to a contiguous parcel and as such, cannot be transferred to a third party or parcel. The granting parcel is the subordinate parcel and the receiving parcel is the dominant parcel. These easements run with the land and are inseparable from the affected parcels. There are two subcategories of appurtenant easements: affirmative and negative. Affirmative easements explicitly grant access or usage rights for such items as driveways or access right-of-ways, sewerage and drainage lines and common walls. On the other hand, negative easements restrict some of the usage rights on the subordinate sight. They include such items as light and air easements and scenic easements.

Criteria	Appurtenant	In Gross
Exclusion	No	No
Use	Yes	Yes
Enjoyment	Yes	Yes
Transfer	No	Yes

Exhibit 5- 15

View Easement Example

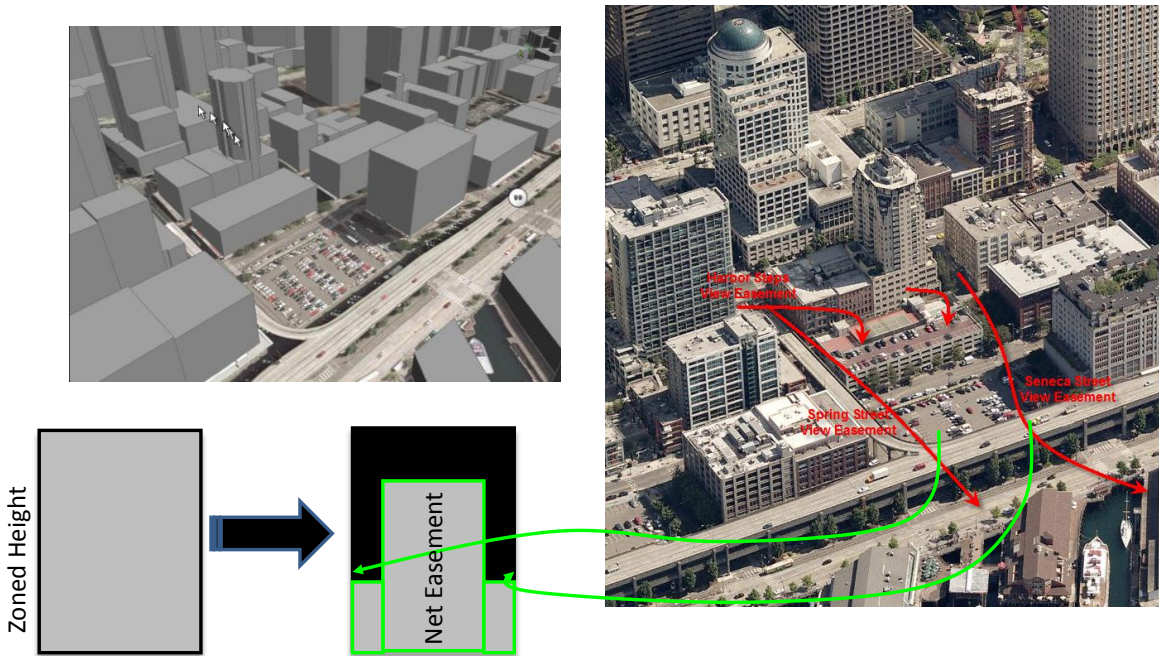


Exhibit 5- 16

Exhibit 5-16 provides an example of a view easement that constrained the development of a NAIOP Student Competition site in Seattle in 2006. As noted, a site to the northeast of the subject property was the dominant parcels and created an easement to protect waterfront views when it sold the parcel to the west. That easement placed a height cap on the development, constraining it lower than allowed under the existing zoning code. In addition, the city created view easements as part of a downtown improvement project which constrained development on both the north and south sides of the parcel. The net buildable area then was the residual in the lower left identified by the arrow, as compared to the zoned building envelop in the far lower left. Interestingly, the private view restriction that affected the height made the dominant parcel the “most likely buyer” since they may have been able to vacate the easement and could thus put the site to a higher and better use than other developers who would have to live within the constraints.

Easements in gross convey the right to use a portion of land or a site that is unrelated to any other parcel. Such rights can be established to allow access to subsurface rights to extract minerals or oil and gas, or surface rights to allow harvesting of timber or crops. Easements can also be provided to allow construction as in the case of building a roadway or railway, laying pipelines, power line, or cable lines, or creating an irrigation ditch. They may also provide for the placement or maintenance of billboards, communications towers or cell towers. They may restrict use as in the case of conservation easements to protect wetlands, preserve land or protect areas of critical concern. Finally, they may allow access for recreational use including hunting, fishing, camping and other uses.

Easements in gross can offer a form of exclusive rights to access, or non-exclusive rights. In the case of exclusive rights, such easements convey all rights associated with the easement. As such, the beneficiary can convey the access grants to third parties. Under a nonexclusive easement, the rights are only conveyed to a single user and cannot be transferred. Note that in this context, the exclusive rights do not restrict access to the owner, but the transfer to other parties by the holder. In the case of retail establishments and multi-use properties, the pattern of access easements for deliveries and customers can create a spider-web of connections that makes it difficult to develop the areas of a site thus encumbered.

In the case of retail establishments and multi-use properties, the pattern of access easements for deliveries and customers can create a spider-web of connections that makes it difficult to develop the areas of a site thus encumbered.

Restrictive Covenants

Restrictive covenants are conditions or restrictions that are imposed on the use or operation of land. They can be created by an owner when conveying land to a new owner. This might occur in the sale of a retail site which carries a restriction on the type of retail uses that can be accommodated on the site to protect the business line of the seller who operates competing facilities in the same trade area. Alternatively, restrictive covenants can be created by mutual agreement as in the case of a Homeowner’s Association for an entire subdivision sometimes referred to as Covenants, Conditions and Restrictions (CCRs). Briefly, CCRs are developed to provide some homogeneity within the subdivision in which owners give up some individual freedom in return for standardization in the nature of land uses, design, features and operation. The underlying objective is to protect land values by defending the subdivision against the risk of value losses and thus advance the common good of all residents. Restrictive covenants can cover a wide range of issues including design restrictions, image/aesthetical restrictions and operational restrictions.

Restrictive Covenants

Design Restrictions	<ul style="list-style-type: none"> •Setback lines, height restrictions for structures •Minimum floor area •No freestanding structures
Image/Aesthetics	<ul style="list-style-type: none"> •No chain-link fences •No garage door facing the street •Required architectural review
Operation Restrictions	<ul style="list-style-type: none"> •No RVs or boats parked in view of the street •No cars regularly parked in the driveway •No external antenna, satellite dish or clothesline •Required use of professional lawn service

Exhibit 5- 17

Covenants are enforced by the courts which respond to complaints from parties of interest. These parties include those in the chain of title as well as those directly affected by what happens in a subdivision. CCR’s may allow for fines which can be filed as liens, but the ultimate resolution depends on court action. Covenants may not be permanent if they are abandoned or no longer serve the same purpose for which they were created. Some states have laws and policies that guide the retirement of covenants.

Types of Liens

Liens

Liens are different from estates or easements in the sense they do not address rights to use or grant access, but create an economic claim against the value of the property. When validated, liens create a “cloud on the title” and are attached to the property until they are discharged. They can be



Exhibit 5- 18

“specific” or “general.” Specific liens are created by some action that is directly tied to the property. For example, an owner may take out a mortgage on a property, pledging the asset as collateral. In this case, the pledge is attached to the property and must be released by payment of the obligation or by some agreement among the parties of interest. In the case of general liens, they can be created by events unrelated to the property (e.g., court judgment).

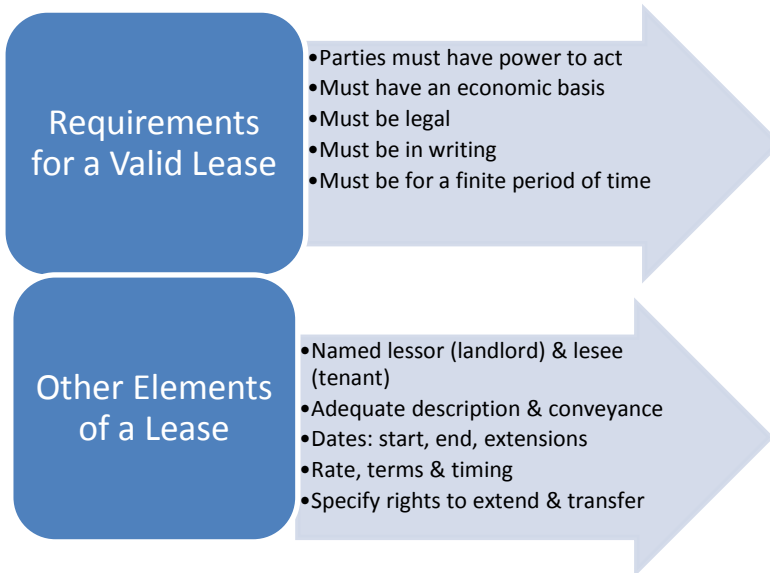
Since the market value of a property may not be sufficient to satisfy all liens, they are assigned a certain priority (i.e., first, second). The lien holders will be compensated in descending order of priority, subject

In general, lien priority is established by first-come, first-served in terms of recording. This gives subsequent lienholders constructive notice (i.e., discoverable with due diligence) that a previous lien exists.

to the availability of capital or other agreement. In general, lien priority is established by first-come, first-served in terms of recording. This gives subsequent lienholders constructive notice (i.e., discoverable with due diligence) that a previous lien exists. The exception is the case of mechanic’s liens which do not have to be recorded to take precedence over a subsequently recorded lien. This favored treatment is related to a public policy decision to protect laborers who are often small businesses from undue economic losses. Thus, a land owner who fast-tracks a project and hires contractors to clear land and/or prepare a site for development may wind up not able to get a development loan since the lender cannot be assured that prior claims have not been created by accident or injury to an employee

Lien holders can also subordinate the priority attached to their claim to help affect a transaction. This would occur with a purchase money mortgage (i.e., seller financing) which could be subordinated or placed behind a permanent loan to satisfy lender requirements for a first priority claim. Liens can be released fully or partially, as in the case of a subdivision or condominium where the development lender releases claims on sites or individual units to allow buyers to obtain a permanent mortgage which requires a first lien position.

Commercial Leases
Lease Requirements



Lease Requirements

To constitute a valid lease on real estate, it must be among parties with the legal ability to act, have an economic component and be in writing. The creation of a lease creates a “leasehold” interest, which is an asset that can be carved up and assigned as collateral or transferred to another party subject to limitations stated in the contract. While a lease is for a specified time, it is often accompanied by options to renew or extend which, if exercised, create another leasehold interest for a period of time. Depending on the terms of

Exhibit 5- 19

the lease, a lease may also be transferred to another party during the period of time over which it operates. In such cases, the leasehold position is a form of finite estate that has value in the market. If a lease is not extended, but the lessee continues to pay rent and the lessor accepts the rent, the lease reverts to a common law month-to-month lease.

Lease Mechanics

On the surface, leases might appear to be rather straightforward. The reality is quite different, especially on the commercial front where leases are long, complicated agreements that spell out the rights and responsibilities of the parties to the lease. This complexity is a reflection of the fact that leases create and/or constrain the revenue producing side of a property which in turn, creates its value proposition. At the same time, the goals and objectives of the parties are somewhat different, with the tenant focused on the right to use and “enjoy” the property, and the owner focused on the value of the property. While some of the goals of the tenant and landlord might be aligned, the tenant’s position is temporary and focused on their own needs while the owner’s perspective is permanent and focused on the property as a whole. This distinction is particularly important in the case of multi-tenant buildings, where the actions of individual tenants can have an impact on other tenants and as such, on the property as a whole. Given this dynamic, commercial leases generally contain usage covenants that determine how a space is used, as well as restrictions on the operation of the property interest. They also address whether the interest is specific to the tenant or can be transferred to another party, and whether they can be extended and if so, under what rules of operation.

While some of the goals of the tenant and landlord might be aligned, the tenant’s position is temporary and focused on their own needs while the owner’s perspective is permanent and focused on the property as a whole.

Selected Leasing Covenants

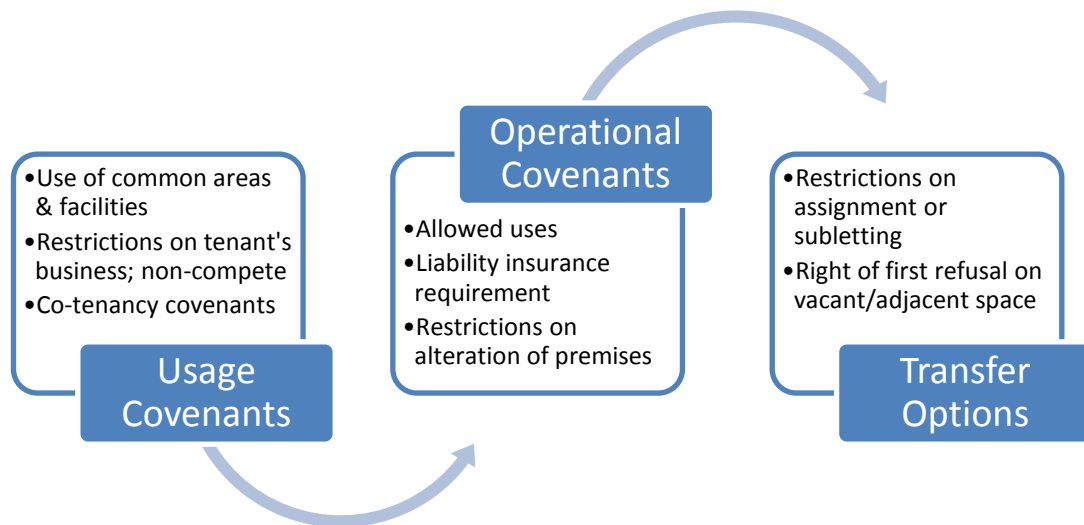


Exhibit 5- 20

Selected Leasing Covenants

Individual leases can contain an almost infinite array of covenants, which could potentially make each one unique. Given the infinite combination of terms and covenants, the absence of standards would make it nearly impossible to compare a bundle of leases from one multi-tenant building to another. To provide some commonality, the market has developed a set of standard lease agreements. However, since leases are negotiated transactions, standard lease agreements can be modified in subtle, but significant

manners. As such, abstracting leases to determine the actual agreement and the economic impact of modifications is an extremely important element of underwriting or valuing a property.

Lease Timing and Economics

Lease Timing and Economics

Since timing is one of the key differentiators between a leasehold estate and freehold estates, a number of temporal issues are important in negotiating leases. The key items focus on the duration or term of the lease. The finite life of a lease creates a conundrum for both the landlord and tenant; should they go long or short? Regardless of the term of the initial lease, a tenant will often want the security of being able to stay put and avoid the expense and disruption associated with moving. This security comes in the form of an option. While some treat this as a

- Temporal Elements
 - Date of agreement
 - Starting date & term of lease
 - Renewal options
 - Right of first refusal to re-lease space
 - Lease cancellation options; kick-out clauses
 - Co-tenancy agreements
- Economic Terms
 - Base or minimum rent
 - Percentage rent (if apply and calculations)
 - Rent changes and method for calculating
 - Tenant improvement allowances
 - Concessions (e.g. free rent)
 - Expenses coverage, expense pass-through

Exhibit 5- 21

free good, in essence the option has some economic value and should be considered in the negotiations. Since the option will have to specify the terms of renewal, and alternative form may be a first right of refusal which would allow the landlord to bump the rent to market rather than having it pegged off of the previous rent as will often be the case with an option. Another form of timing issue addresses the landlord’s risk that a tenant is underperforming and thus dragging down the productivity of the property. While this might not appear to be a major issue, in the case of shopping centers in which the synergy of

Tenants can also protect themselves from erosion in the rent roll by creating co-tenancy agreements that tie their lease term to the continued operation of named tenants with who they determine are critical to their own success.

tenants is important to the success of the center, it may be a critical element. To address this risk, kick-out clauses can be used to vacate a lease and free the space up for a more productive, complementary tenant. Tenants can also protect themselves from erosion in the rent roll by creating co-tenancy agreements that tie their lease term to the continued operation of named tenants who they determine are critical to their own success.

In addition to the timing, lease agreements specify the economics of the individual leases, as well as how they relate to operation of the overall property. At a minimum, the economic considerations address the base or minimum rent. The agreement should also specify any contingent rent including percentage rents which will typically be tied to retail sales. If applicable, the definition of in-store sales should be noted to deal with Internet orders and pick-ups, as well as reporting requirements to ensure compliance. If the rent changes during the term of the lease or when an option is exercised, the method for calculating new rents must be specified. To protect the tenant from high adjustments, the new rent

levels are often indexed off of the initial rents using some pre-determined index. It should be noted that while this is a reasonable approach, it can result in contract rents that are materially different from market rents. The lease should also specify any tenant improvement allowances (TIs), free rents or other

concessions both at inception and upon renewal or extension. If TIs are allowed, the timing, method of disbursement and responsibility for construction management and contingent cost recoveries should be noted. Finally, the lease should specify how expenses are covered and if there is any tenant participation, how the amounts will be billed relative to the overall property and other tenants.

Types of Leases by Expense Options

There are four basic types of leases with respect to the question of which party pays which of the operating expenses. The gross lease is at one end of the spectrum with the tenant paying a fixed amount and the landlord covering all expenses. The “fixed amount” may actually escalate according to some index or predetermined schedule. Since the landlord will absorb all expenses, the gross rate will be higher than with some of the other options to cover expenses and the risk of rising costs. At the other end of the spectrum, the base rate for a NNN lease will be the lowest since the tenant assumes the cost of operating expenses and the risk of rising costs.

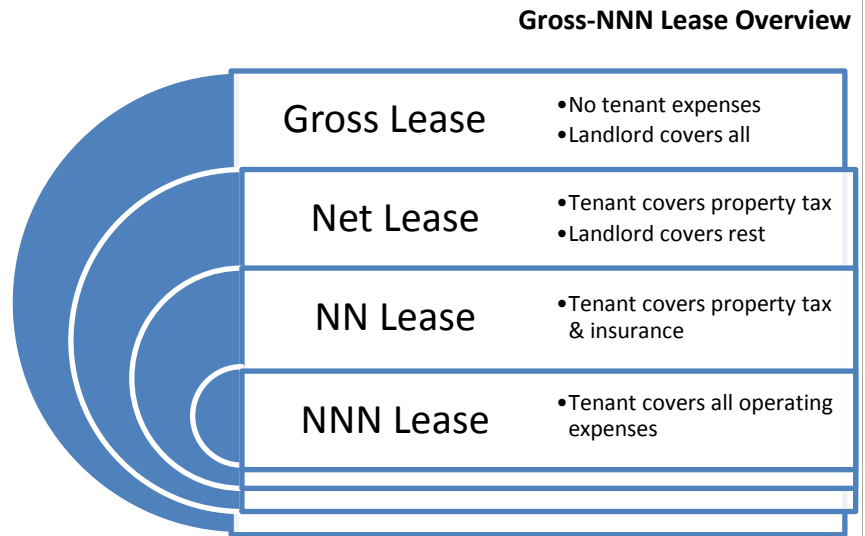


Exhibit 5- 22

Lease Terms and Green Buildings

It should be noted that the use of NNN vs. Gross Leases has a significant impact on the costs and rewards of developing new --or converting existing-- buildings to more energy efficient or green buildings. That is, the costs of such investments are generally born up front and thus affect the development or acquisition costs. While there is some evidence these costs can be materially reduced if the building goes green from inception, they are still incurred up front. In addition to the actual costs, there is some risk that the mechanicals, design and maintenance costs may be higher than traditional buildings. Finally, in the absence of long-term empirical data spanning, there is no guarantee that the promised energy savings will be realized by the owner.

This caveat is especially true when competitive leases are NNN. In such cases, the tenant pays all the expenses and as such will be the party that benefits from any lower operating expenses. Thus, the only way for the owner to get a return on green investment or to neutralize the cost premium is to be able to charge a higher NNN base rate. To date, many tenants haven't shown a willingness to pay more base rent, especially since the economic benefits associated with lower operating costs have not been tested over time. While not arguing against such development and contending that the real estate industry should have been applying “sustainable” practices all along, the economics and cost/benefit equation should be noted. This is especially true for existing buildings where the costs of retrofitting are much higher than those associated with new buildings. In a free market economy, these issues should be resolved with market-based solutions rather than legislative mandate or regulations that may themselves not be sustainable and have a variety of unintended consequences.

Multi-Tenant Expense Allocations

In the case of multi-tenant buildings, tenants are often responsible for a portion of operating expenses. As such, the allocation mechanism should be specified in the individual leases to protect the tenants against unfair charges. In many markets, the tenants are allowed an expense allocation up to the floor or base level which is set at the time they execute the lease. To protect the landlord from unexpected inflation, the tenants are billed back on a prorated basis for expenses that exceed their relevant floor or base rates. Since leases are often staggered, tenants will be paying different levels of reimbursement as well as base rents. For example, if expenses are at \$4/sf when the first tenant signs and then \$4.50 when the second tenant signs. If the actual expenses are under \$4/sf, there are no reimbursements. If they rise to \$4.50, the first tenant reimburses the landlord for the \$.50 over their floor and the second tenant has no expense reimbursement. At \$5/sf, the first tenant reimburses \$1/sf and the second \$.50/sf. This same calculation is applied to all tenants, although the terms negotiated. Since the relative power between the landlord and tenants shifts over time, the treatment of expenses can become a complex array. The fact that the ability to raise rents and push tenants on expense reimbursement schedules are highly correlated punctuates the importance of staggering rent rolls to dampen cyclical swings in value. This is especially true since cap rates and yield requirements are negatively correlated with market conditions. Thus, deterioration in market fundamentals could lead to a perfect storm, with falling rents, rising expenses and rising cap rates undercutting values.

...the fact that the ability to raise rents and push tenants on expense reimbursement schedules are highly correlated punctuates the importance of staggering rent rolls to dampen cyclical swings in value.

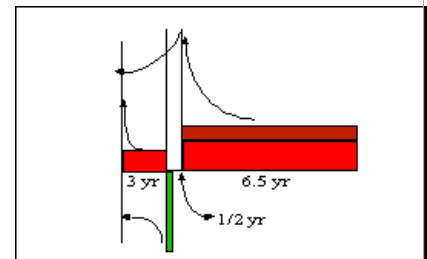
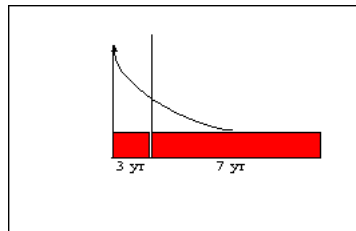
Commentary 5- 1

Lease Economics

While the financial implications of leases will be discussed later, this is a good time to call attention to the importance of rent roll management. Consider the two cases illustrated in Exhibit 5-19: a Situational Decision that is entered without much thought, and an Enduring Decision which seeks to protect market values and satisfy best practice standards. Up to this point, the discussion of real estate valuation has been fairly simple, relying on annuitized models (e.g., fixed payments in perpetuity) underlying overall cap rates and the Frontdoor/Backdoor Models.

Lease Economics: Situational vs. Enduring Cases

Situational: Base Case



Enduring: Value-Add

Exhibit 5- 23

While useful in screening deals, cap rates and other annuitized models lack the precision to account for changes and the Time Value of Money (TVM) considerations to put options on a common ground that should ultimately be built into real estate finance and investment analysis. This can be illustrated without adding too much complexity.

As noted in the Base Case in Exhibit 5-19, a landlord has a 10 year planning horizon for space that is occupied by a tenant whose lease is up in three years. To keep it simple, in the Base Case the landlord assumes the tenant will merely lease the property at the same rate, exercising a 7 year option to renew. In the Enduring Case, however,

...it might be in the best economic interest of the landlord to voluntarily offer to cut the existing tenant's current rent, reduce the renewal rent and throw in some other economic incentives to get them to renew.

the landlord realizes: 1) the market has dramatically softened, and 2) the tenant may well not automatically renew forcing the space to go to market. Clearly, the landlord is not indifferent to what the tenant does and should consider whether some incentive might be in order to shift the probability of renewal into their favor. That is, if the tenant does not renew, the landlord may be faced with a potential cash solvency issue, especially if the market remains soft as they anticipate. If that occurs, the landlord may have to compete for new tenants which could involve eating vacancy for 3 months, offering 3 months of free rent, paying for new Tenant Improvements which could be avoided with a renewal, and paying new leasing commissions up front which are twice the renewal rates. After all that, they would only have a residual of 6.5 years of rent collections after the 6 months of no rental payments.

Using these facts and some basic real estate finance models, the landlord could solve for the residual rent premium in the upper right that would have to be charged to hold the present value equal to that in the Base Case. While rising rents and strong market fundamentals might make the numbers work, if the market is indeed soft, the economics may well not work out, creating erosion in value. This situation could be exacerbated if the property or leasing was focused on the tactical issues of filling the space and may not be tuned into the financial side of the equation. Thus, it might be in the best economic interest of the landlord to voluntarily offer to cut the existing tenant's current rent, reduce the

renewal rent and throw in some other economic incentives to get them to renew. This is especially true if the tenant plays an important part in the rent roll.

Ground Lease

A ground lease is a means of controlling real estate for a long period of time without actually purchasing the land. In effect, a ground lease is a long-term lease on land in return for a promise to pay and a commitment to develop with certain specified improvements. This ensures the owner of the land will have a cash flow during the lease and the opportunity to capture property value at the end of the lease when the land and improvements thereto automatically transfer to the land owner. While not as clean as an outright purchase, a ground lease has several advantages for a seller.

- First, it can help the seller avoid capital gains taxes.
- Second, it can help with estate planning, retaining a future ownership position in the land and the buildings or improvements that are placed on the land.

Ground Lease Economics for Seller

- Third, it can create a relatively safe bond-like income stream which is collateralized by the land and the improvements placed on the land. Consider the following:
 - The value of the land is \$1,000,000, at a 6% rate of return the owner would receive \$60,000 per year in lease payments.
 - If the owners cost of capital was 5%, the PV of those

Item	Amounts/Rates
Value	\$1,000,000
Return	6%
PMT	\$60,000
Cost Capital	5%
Term	99
PV of PMT	\$1,190,418

Exhibit 5- 24

benefits would be \$1,190,418 which is greater than the value of the property today and with a safer return due to the collateral value placed on the property.

Although a ground lease has some limitations and will not be acceptable to all owners, it does have some advantages for the buyer.

- First, it can motivate a seller to transfer development and usage rights for a prime parcel that would not be available for sale if it required relinquishing all ownership rights. This is particularly true with urban retail or office sites located in a CBD core.
- Second, it can reduce the upfront cost of the property and thus development. For example, land is typically 15-20% or so of the total cost of an operating property. Since the buyer does not have to raise that portion of the capital up front, it can lower the carrying costs and shift the burden to the operating side.
- Third, it can create a more tax efficient investment, increasing the depreciable percent of the investment relative to the total since the land is not depreciable.
- Fourth, the ground lease is a leasehold interest. Given its long-term nature, the lessee may be able to obtain a permanent mortgage and attract sufficient capital to develop a major project on the site. Once developed, the property can be sold to a third party allowing a developer to create and capture value on disposition with relatively limited capital.
- Finally, due to the time value of money, the present value of the ultimate loss of the improvements to the land and the leasehold interest are rather limited. A ground lease is typically a long-term lease (e.g., 50-99 years) on a property that vests the lessee (i.e., tenant) with the right to use, enjoyment and exclusion during the term of the lease. While the property will revert to the lessor at the end of the lease, the net earnings in the interim may be more than adequate to offset the eventual loss of ownership.

Lease Economics for Buyer

Item	No Inflation	Property Inflation	Present Value
FV	\$5,000,000	\$35,512,971	\$35,512,971
Rate	6%	2%	6%
Term	99	99	99
Periodicity	12	12	12
PV	\$13,356	\$5,000,000	\$94,865

Exhibit 5- 25

In this case, assume the lessee (i.e., buyer) is going to put a \$5 million improvement on the site. If they had to walk away from that at the end of 99 years, at a 6% cost of capital due to the discounting of money the PV of the loss would only be \$13,356. Now, assume the property appreciates at 2% per year for 99 years. At that point, due to the

compounding of money the future value of the property would rise to some \$35 million. While that seems like a lot today, in PV terms due to discounting at the 6% rate the present value would be only \$94,865. Interestingly, that would only be 2% of the improvements of \$5 million, a lot lower implicit land cost than would otherwise be borne by the lessee if they had to purchase the land outright.

Real Estate Contracts

Space Producers, Space Users and Space Facilitators

A variety of contracts and legal agreements are put in place throughout the life cycle of a real estate product. These contracts establish the relationships among parties including space users, space producers and facilitators/infrastructure providers.

Major Players in Real Estate Market

- **Space Producers.** Briefly, the category of real estate producers covers the parties who actual develop, own or invest in real estate. They provide materials, labor, capital and expertise. In the case of new real estate, the developer is the quarterback of this team, charged with marshaling, motivating and directing the resources to ensure a project is delivered. In the case of existing real estate, these responsibilities are assumed by the owner or manager of the space. In addition to business objectives, the binding agent that pulls the parties together is the set of contracts that they execute among themselves. To avoid litigation and crisis management, these contracts should address what, when, where and how the relationship should work, but then also address what happens when things don't turn out as expected. However, since contracts cannot anticipate all issues or situations that arise, the nature of the relationship and the personal and corporate integrity and commitment to resolve issues that periodically arise is also important to the long-term success of ventures or projects they undertake.
- **Space Users.** Space users focus on those directly involved in real estate due to ownership, control of rights or contractual agreements. Some of these rights were created in prior periods and flow with the property (e.g., reversion, restrictive covenants, easements), while others are created when the rights are transferred to another party. In general, space users are focused on enjoying the use of the property and other benefits it bestows, either in perpetuity or for a finite period of time. The nature of that use and the extent of their exclusive enjoyment is defined by a set of contracts. These contracts also govern their relationships with other players including space producers who create the property and space facilitators who support its on-going use and/or set the regulatory context within which it operates. Some of these arrangements are also contractual, while others may be legally imposed and subject to judicial scrutiny.
- **Space Facilitators/Government.** The category of real estate facilitators include the public and private parties that are directly or indirectly involved in the real estate market. Some of this involvement is market-based, with the rules of engagement specified under a set of contracts. Others emanate from the public side of the market and typically are activated through a set of formal policies and procedures. However, the public side also engages in contractual commitments with space producers, providing a degree of flexibility that can address particular issues that may arise.

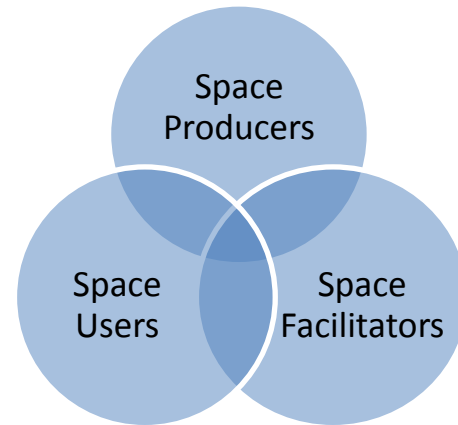
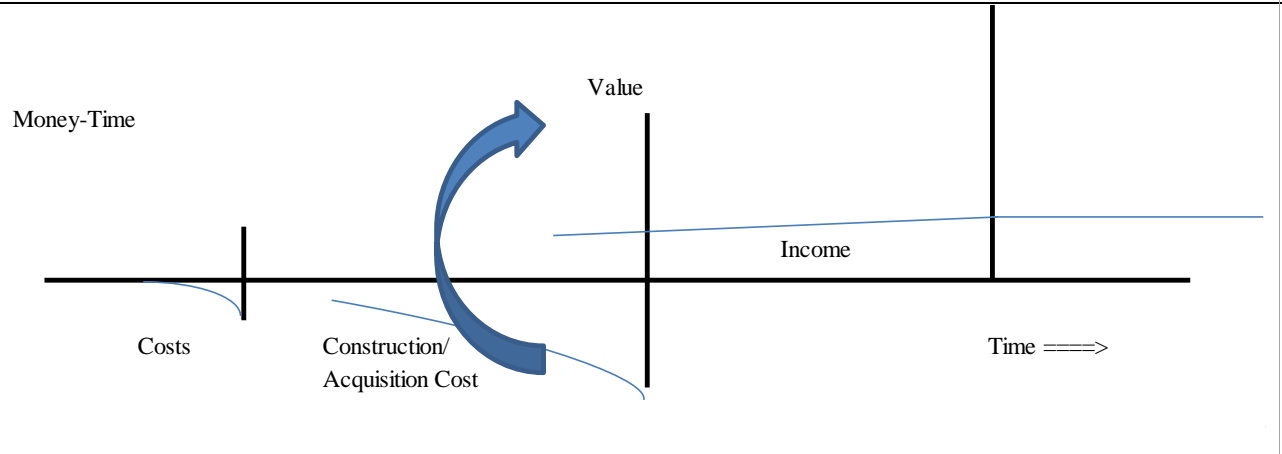


Exhibit 5- 26

Contracts and Agreements: A Life-Cycle Snapshot



Planning	Acquisition/Production	Operation	Disposition
Space Producers	Acquisition	Leases	Assignment Agreement
Architect	Bilateral Contract	Boilerplate Lease	Carve-Out Agreements
Consultant	Buyer Agency Agreement	Lease Abstract	Exclusive Listing Agreement
Contractor	Counteroffer	Lease Agreement	Hold-Harmless Agreements
Engineer/Environmental	Sales Contract	Lease Amendment	Listing Agreement
Legal Services	Development	Lease Assignment Agreement	Satisfaction of Mortgage
Non-Disclosure Agreement	Architectural Design/Inspect	Lease Commission Contract	Sales Contract
Preconstruction Docs	Bidding Contract	Percentage Lease	Purchase Contract
Request for Proposals (RFPs)	Contractor Agreement	Preliminary Lease	Release Agreement
Venture Documents	Construction Documents	Rental Agreement	Termination Agreement
Site Acquisition/Control	Construction Mgmt. Agreement	Temporary Occupancy Agree.	
Call Option	Const. Oper & Reciprocal Easement	Insurance Agreements	
Forward Contract	Cost-Plus Contract	Property Insurance Contract	
Land Contract	Design/Build Contract	Rental Insurance Agreement	
Option to Purchase	Easement, Rest & Op. Agreement	Maintenance & Operations	
Space User Pre-leasing	Lump-Sum Contract	Custodial Maintenance Agreement	
Letter of Intent	Time & Materials Contract	Fee Management Agreement	
Forward Lease Commitment	Turnkey Agreement	Maintenance Agreement	
Contingent Lease Agreement	Financing	Marketing Plan	
Space Facilitators/Government	Construction Loan Agreement	Negotiated Contracts	
Density Bonus	Land Dev. Loan Agreement	Operating Expense Agreement	
Environmental/Wetlands	Interim Loan Agreement	Property Management Agreement	
Exaction Agreements	Loan Lock Agreement	Service Agreement	
Impact Fees	Insurance Contracts	Standard Operations Agreement	
Utility Connection Agreement	Bid Bond Contract	Tenant Relations Agreement	
	Builder's Risk Ins. Contract	Unilateral Contracts	
	Completion Bond Contract	Financing	
	Guaranteed Max. Price Contract	Carve-Out Fin. Agreement	
	Hold Harmless Agreement	Mod. & Assumption Agreement	
	Performance Bond	Mortgage Pledge Agreement	
	Personal/Corp. Guarantees	Mortgage Servicing Agreement	
	Public Agreement/Documents	Permanent Mortgage	
	Building Permit	Permanent Loan Note	
	Development Agreement	Loan Lock Agreement	
	Notice to Proceed		
	Certificate of Occupancy		
	Compliance Certifications		

Exhibit 5- 27

Real Estate Contract Overview: A Life Cycle Perspective

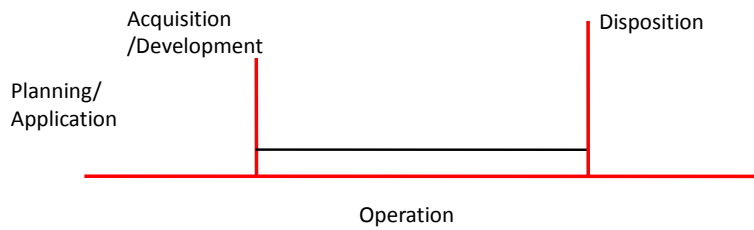


Exhibit 5- 28

There are an also infinite number of contracts that can come into play during the planning, acquisition/development, operation and disposition of real estate rights. While some of these contracts and agreements will be discussed in more detail in other chapters, it is useful to explore how pervasive they are across the life cycle and beyond (e.g., environmental liability). The discussion should also demonstrate that added importance the legal dimensions of real estate take on as part of the critical factors underlying a successful real estate project. To help structure the discussion, the individual contracts and agreements are presented in chronological order although many carry forward from one stage to the next. Where appropriate, the parties and related agreements and contracts are isolated. While the list is fairly comprehensive, it should be noted that it does not cover the full range of contracts and agreements



necessary to support the real estate industry. Furthermore, the discussion focuses on the spatial markets, with moderate coverage of the capital markets and the myriad financial instruments, regulations and nuances necessary to support it.

Planning Stage

In theory, the planning stage is a preliminary stage in which a developer or other project initiator explores the viability of developing or acquiring a project. In reality, the phase may be more perfunctory, with the go decision already made and the emphasis on configuring the action plan to make sure the “eureka” notion can be developed. Regardless of the motivation, a number of contractual agreements are necessary during this phase to manage the process and make sure that some “deal points” are not inadvertently ignored. In general, most of the players involved in these discussions will be fee-based, but will have their fees tied to the services they render during this phase rather than to the decision to actually develop a project or to its long-term success. This is important since it takes some of the “agency effect” or bias out of the question. However, the motivation, personality and style of the primary decision-maker can impose a pro-development bias on the parties.

Real Estate Producers

Professional Design & Planning Services

- **Architectural and/or Pre-architectural Contract.** During the planning stage, an architectural contract may be awarded to develop a conceptual or schematic representation of a potential building. This assignment may be limited in terms of detail but sufficient to allow the developer to solicit inputs from planners and zoning bodies, preliminary cost estimates,

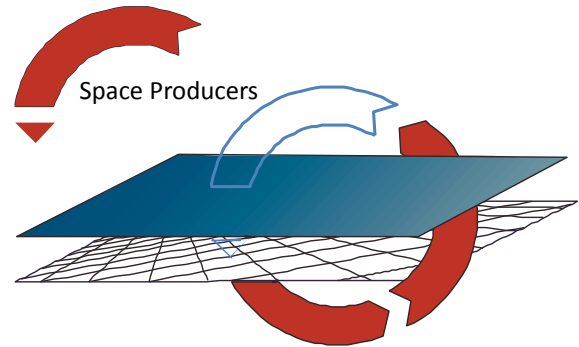


Exhibit 5- 29

- **Consultant.** Consultants provide a range of advice, consulting and decision-support regarding a proposed venture. These may include market studies, feasibility studies and other services. The contracts establish relationship between two parties regarding the provision of professional services and specify the scope of services, responsibilities and compensation agreement.
- **Contractor’s Preconstruction Services.** During this preliminary stage in which a project is being scoped out, formal contractual agreements are somewhat premature. However, the project planners may need a set of documents that can guide the soliciting and selecting bids for the construction award in the event the project goes forward. The services will include the preparation of the bidding documents, advertising and solicitation of responses. The documents may also address the selection process and final negotiations with the contractor.
- **Engineers/Environmental Specialists.** Depending on the nature of the project and the land and location, professional services may be required to assess the physical possibility of constructing a proposed project as well as the special design elements that may be required. In addition, the site may be located in wetlands, areas of critical concern or other protected areas that require special permits. Alternatively, the site may have some environmental issues and/or require remediation which much be identified and managed. The contracts with engineers, environmental specialists and other specialists specify the terms, responsibilities and liabilities of the parties with respect to such expert services.
- **Legal Services.** While legal representation regarding the ultimate project or transaction may be somewhat premature, some form of legal agreement is necessary to draft and oversee the contractual relationships among the various professional service providers. To provide continuity of support, the legal documents may provide for phased or staged services, as well as provide flexibility to ensure the appropriate level of legal direction and support are retained.
- **Non-Disclosure Agreement.** A contractual agreement among several parties that restricts the provision of information regarding specified items not in the public domain.
- **Request for Proposals (RFP) Contracts.** A contract that solicits submissions or bids for a particular job which lays out various



requirements and tasks to be considered in selecting a winning bid for a project. Does not constitute an offer to enter a contract, but a solicitation for information to be considered in selecting a party.

- **Venture Documents.** An agreement or set of contracts and agreements that defines the terms of ownership in which two or more parties operate in tandem. In such agreements, all parties may accept responsibility for the actions and outcomes of the venture depending on the nature of the venture and the contractual provisions established up front. Depending on how it is structured, the various parties may be able to bind others to future contractual and legal agreements.



Site Acquisition/Control Documents

- **Call Option.** A unilateral right to purchase an asset, property or interest at some point in time at some specified price without an obligation to exercise the right. In the case of land, the right can be assigned to the option to construct a property that generates income or rent.
- **Forward Contract.** A contract to purchase some specified property or property rights at some future date under certain terms or conditions.
- **Land Contract.** A contract of deed transfer which is distinguished by its fairly long term (i.e., over 10 years) and the transfer of occupancy rights during the contract period. In such arrangements, the rights of the two parties are analogous to that of a mortgagee and mortgagor.
- **Option to Purchase.** Creates a formal contract specifying the terms and conditions under which a property may be sold if the option is exercised at a fixed price during a fixed period of time. The option may or may not be associated with a fee and requires the negotiation of a separate purchase agreement.

Real Estate Users

Tenant Preleasing Agreements

During bull phases of a market, a developer may be able to obtain financing and capital commitments for speculative buildings. These are buildings that are constructed without any tenant commitments but are built on the “build it and they will come” assumption. In more normal times developers must achieve a certain level of preleasing to activate a construction loan or trigger contingent commitments from other sources of capital.

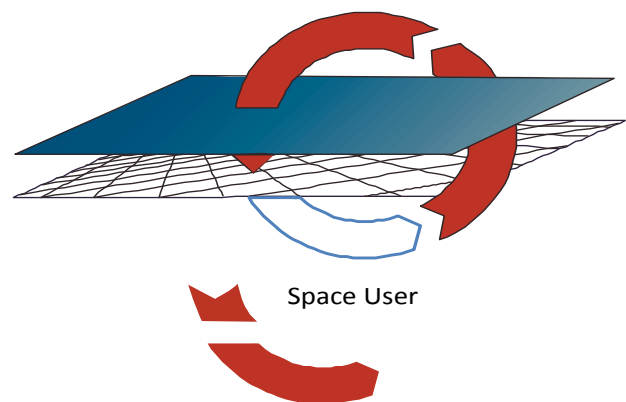
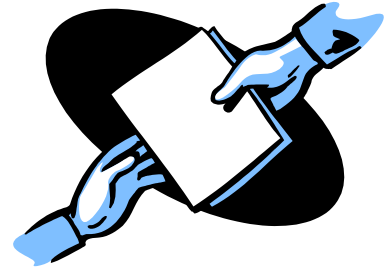


Exhibit 5- 30

- **Letter of Intent to Lease.** This is a non-binding agreement which specifies the lessees intent to enter into a lease at some future completion, delivery or due date. The agreement may be non-binding and may be of the form of “mandatory delivery, optional acceptance.” Under such an agreement, the developer or owner must make the premises available and the tenant may or may not enter into a contract and accept

delivery. There is an assumption of good faith efforts to consummate an agreement but no penalties or explicit criteria are established since there is no underlying economics at the time of creation.

- **Forward Lease Commitment.** This is a binding contract in which the two parties agree to the major terms of a lease for specified premises that will be delivered in a specified condition at some specified point in time. The failure to deliver on the contract can contain penalties as well as an option to void the agreement. The agreement may be associated with a prepayment or some form of monetary compensation.
- **Contingent Lease Agreement.** The non-binding prelease agreement in which the future lessee specifies certain contingencies that must be achieved in order to activate a previously negotiated lease of intent to enter into an agreement. If the contingencies are satisfied, the lease is activated with no additional negotiations.



Real Estate Facilitators

Space Facilitators/Governmental Body Approvals

- **Density Bonus Contract.** An agreement relying on an established incentive program that increases the maximum development intensity or usage of a particular area or site

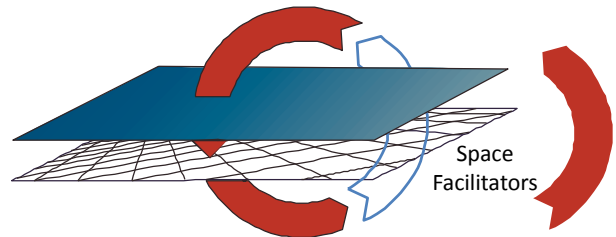


Exhibit 5- 31

in return for satisfaction of some specified criteria (e.g., green buildings, affordable housing) to achieve desired social or community goals.

- **Environmental/Wetlands Approvals.** If necessary, these documents address any environmental issues and/or remediation requirements for a site. These discussions can be far-reaching, ranging from federal requirements to local jurisdictional requirements.



- **Exactions.** Mandated contributions of property, property rights, improvements or other assets in order to secure approvals, entitlements or permits to allow development. Typically used to ensure adequate public spaces associated with new development or to fund needed improvements for roads or other infrastructure.

• **Impact Fees.** An assessment or charge levied by a local governmental body to help offset or cover the costs of connecting or building public services to the new development. in terms of providing capacity to service or support the additional burden. A revenue-generating tool used by many jurisdictions to raise capital to defray or offset the costs of providing services to new users.

- **Utility Connection Agreement.** A commitment to allow a property to connect to public utilities. This agreement may require a type of "impact fee" in which utilities charge a "tap fee" for connecting to an existing system to raise capital to defer or offset the costs of providing services.

Acquisition/Development Stage

Acquisition/Purchase Contracts



- **Bilateral Contract.** In a purchase and sale contract, the requirement that both parties must carry out certain responsibilities to achieve full performance unless they are specifically waived by a party who is the beneficiary of the condition(s).
- **Buyer Agency Agreement.** A formal contractual agreement in which a buyer engages a broker or agent to provide services.
- **Counteroffer.** A response that is made to an offer in which the offeree presents a compromise or alternative. This new offer supplants the original, which is no longer binding unless the new offer is received and/or responded to with another offer.
- **Sales Contract.** A document signed by a seller and buyer that identifies the property being transferred, any warranties or guarantees, the consideration and form of payment, and any other conditions upon which the transaction depends.



Detailed Design/Construction Contracts

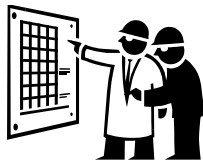
- **Architectural Design/Supervision Contract.** During the actual design/construction phase, the architectural contract addresses the specific services and deliverables to be prepared by the architect and related disciplines they may coordinate on behalf of the developer. The services can focus on developing working drawings, as well as material and labor specifications. The architect may also provide design review and monitoring services to ensure the project gets built per specification.
- **Bidding Contract.** A process in which a developer, contractor or owner solicits proposals for construction or other services from third party providers. The process seeks the most competitive alternative in the market based on costs, quality, expertise or other criteria established by the party seeking the services.
- **Contractor Agreement.** A formal contract that establishes the services, conditions and terms under which one party provides as an independent partner on behalf of another party.
- **Construction Documents.** The set of construction agreements that are executed to formalize the obligation of a contractor with respect to construction drawings and specifications. The agreements also typically establish procedures for dealing with modifications and other changes. A complete package of documents will address construction and post construction services.
- **Construction Management Agreement.** A contract that directs the provision of professional oversight with respect to the construction or redevelopment of a property. This contract is designed to protect the interests of a client. It addresses oversight and review of various construction activities acting as an agent on behalf of a client. The construction manager becomes an intermediary between an investor/owner and a general contractor and subcontractors.



- **Construction, Operating and Reciprocal Easement Agreement (COREA).** A form of agreement for development and construction which encompasses the overall process and spans the continuum of time running from inception to operation and disposition. Allows the respective parties to have the necessary access and time to complete a development. To protect the parties, the agreement specifies the rights and responsibilities of the parties of interest.
- **Cost-Plus Contract.** A construction cost contract arrangement in which the base price is set, but the ceiling remains open end depending on changes in design, materials or other specification.
- **Design/Build Contract.** A development contract in which the architectural and construction services are blended into a single contract. This contractual arrangement between an owner and other entity is also known as a single-source contract.
- **Easement, Restriction and Operating (ERO) Agreement.** A document that specifies the various constraints, rights and agreements that are made to ensure that a property can be accessed as needed to ensure it can be successfully developed and then, upon completion, operated. The agreement also helps ensure that future tenants will be able to conduct business without unnecessary interference or obstacles.
- **Lump-Sum Contract.** A form of construction bidding in which the contractor provides an all-in cost based on completed working drawings and material specifications. The contract does not isolate individual components and does not necessarily reflect the actual costs or normal profit margins of the bidding contractor.
- **Time and Materials Contract.** A construction contract in which the prices are established for various components or activities using unit prices. Such a contract may or may not include an upside limit or cap on costs.



- **Turnkey Agreement.** A type of construction arrangement in which a developer oversees and facilitates the development of a project per mutually agreed specifications. These specifications lay out the quantity and quality of the ultimate property as well as the time frame and financial commitments that justify its development. Upon completion of the project, the developer then simply turns the keys over to the buyer in a state that renders it ready for immediate occupancy, use and enjoyment.



Construction Finance Contracts

- **Construction Loan Agreement.** A contract that establishes the terms of a generally short-term, high risk loan. This loan is used to fund development, redevelopment or other construction activity. The interest rate and fees on construction loans are typically higher risk and full recourse. This is due to the fact that until the project is completed, there is no income-generating potential if a project is not completed and the lender must rely on limited collateral.
- **Land Development Loan Agreement.** Loans or mortgages that are issued to the owner of undeveloped land to provide funds for on-site and off-site improvements. Loan proceeds can also sometimes be used to cover legal costs associated with needed entitlements, permits and approvals.



- **Interim/Standby Loan Agreement.** This is a contingent commitment to offer temporary gap or bridge funding in the event of cost overruns or a failure to achieve certain take-out requirements related to preleasing and/or project completion.
- **Permanent Loan Lock Agreement.** A written statement that documents the agreement between a lender and prospective borrower in terms of the forward commitment of funds at a specified rate and specified terms and conditions.

Construction Bonding & Insurance Contracts

- **Bid Bond Contract.** A bond that is issued by a contractor or other party to ensure that if the bidder's submission is accepted, the contract requirements can be discharged with sufficient capital resources to ensure success.
- **Builder's Risk Insurance Contract.** Insurance which is provided to indemnify a contractor for risk exposures that may occur during the construction period.
- **Completion Bond Contract.** A type of insurance or bond obtained by an owner or developer that guarantees the timely completion of a project consistent with plans and specifications for materials and quality.
- **Guaranteed Maximum Price Contract.** A construction contract that specifies the maximum price that can be charged by a contractor for a particular product or service. Such agreements are designed to manage risk and allow a developer to avoid cost overruns or escalations due to inflation, delays or other forces. Cost overruns can still occur due to acts of God, war or other forces that make it impossible to perform. To cover contingencies, the cost of this form of insurance are built into the construction costs laying of certainty for cost efficiency. Change orders and other revisions may trigger an increase in the maximum price as established in the original contract.
- **Hold Harmless Agreement.** A legal agreement in which various parties agree to insulate other parties from certain risk exposures, thus absorbing the underlying risk and insulating the other parties.
- **Performance Bond.** A bond issued by a contractor or other party providing goods or services to ensure that a project or activity is performed in an acceptable manner in an acceptable period of time thus helping guarantee completion of a job.



Public Construction Agreements/Contracts

- **Building Permit.** A formal document that is issued by a municipality or other jurisdiction which enables a developer, contractor or owner to commence construction. The issuance of such a permit is based on satisfaction of various requirements that are set by the issuing body including zoning requirements, plan approvals and other regulations and restrictions.
- **Development Agreement.** A formal agreement or contract between a developer and a regulatory agency or municipality which is executed as a by-product of a zoning or permitting process that authorizes construction to commence.
- **Notice to Proceed.** A formal, written document that authorizes a contractor or service provider to commence construction and sets a starting date.



- **Certificate of Occupancy.** A written statement that signifies that a property is habitable and ready for move-in by tenants and/or users. The requirements or standards regarding when this stage is reached vary by jurisdiction. The ultimate certificate or clearance is typically issued by a building inspection office.
- **Compliance Certification(s).** These statements will vary from jurisdiction to jurisdiction. They are designed to certify that the project complied with required standards under zoning codes, building codes and other local, state and federal requirements.

Closing/Operation Stage

Tenant Lease Contracts

- **Boilerplate Lease.** Standardized language in a lease or contract that is generally fixed and non-negotiable; consists of the standard language or terms that are used in the particular market or type of contract.
- **Certificate of Completion.** A formal document issued by an architect or other party that certifies that construction activity has been completed.
- **Lease Abstract.** A statement or document that extracts the key components of a lease agreement including such items as names of the parties, delineation of the space, specification of consideration, time frame, options, concessions, and covenants.



- **Lease Agreement.** A contractual agreement between an owner (lessor) and tenant (lessee) that stipulates the rights and responsibilities of the two parties with regard to specified property; includes such provisions as the term, payments, treatment of expenses, caveats on use, and other items.
- **Lease Amendment.** A formal contract that modifies, extends or replaces an existing lease agreement between and landlord and tenant.
- **Lease Assignment.** A contract by which a tenant transfers all or some rights to occupy and enjoy certain premises to a third party. The original lease agreement may restrict these rights and/or specify the conditions under which they occur and can be transferred.
- **Lease Commission Contract.** The contract that specifies the fee that is paid to a leasing broker or other agent in return for securing a tenant for a property. The level of the fee is related to market conditions and practices. The fee is typically payable upon execution of the lease. A lower commission rate is generally paid for tenants who renew for the same space.
- **Percentage Lease Agreement.** A contractual agreement which conveys the right to use or occupy certain space in return for a combination of fixed and variable payments where the level of compensation is tied to the revenue generated in the associated space.
- **Preliminary Lease.** A non-binding, initial draft of a lease agreement that lays out the key parameters of the proposed lease. Upon approval of both parties, the draft has a presumption of validity under common law interpretations. Rather than firm guarantees, it becomes a good faith document.
- **Rental Agreement.** A formal, written agreement that specifies the terms of the lease. It addresses key items including rent, expense reimbursements, common area maintenance charges, term, and any renewal rights. It also specifies a number of covenants that establish a set of rules that must be honored during the lease



- **Temporary Occupancy Agreement.** A formal agreement between a landlord and a tenant that reflects the temporary use of space prior to the formal reception.

Operating Insurance Contracts

- **Property Insurance Contract.** A formal insurance policy that protects the owner or beneficiary in the event of losses due to specified causes such as fire, storm, earthquake or other natural disaster



or manmade event. Contract will identify extent of coverage, claims processes, deductibles, exclusions, limitations, and other conditions.



- **Rental Insurance Contract.** An insurance contract that provides supplemental rental payments after a catastrophic event that makes it impossible for tenants to occupy the premises thus releasing them from rental payments.

Operating Maintenance and Management Contracts

- **Custodial Maintenance Contract.** A contract that guides the on-going cleaning, maintenance and other housekeeping items necessary to operate a property.
- **Fee Management Contract.** A contract between and owner and a third party professional who steps into an operating agreement and provides fee-based services on behalf of the owner or client. The fee manager operates as an independent agent.
- **Maintenance Agreements.** A general agreement that guides the general care and upkeep of a property to handle on-going or normal expenses. These expenses are generally determined to be necessary to keep the property in acceptable condition for normal and productive use.
- **Marketing Plan.** A strategy statement that outlines a marketing program for a specific product, service or business. This program addresses how the marketing mix of product, price, place, promotion and physical distribution will be blended over time. The plan also establishes the budget, strategies and tactics that will be incorporated as well as the metrics that will be used to judge the performance of the overall program.
- **Negotiated Contract(s).** A type of contractual commitment for the provision of goods or services in which mutually acceptable terms are established through the interaction of the buyer and seller or other parties involved in the negotiation of a final contract.
- **Operating Expense Agreement.** A document that guides how operating expenses associated with managing a property are to be handled. Typically refers to expense related to property management, but may also be related to other services that are performed on behalf of, or by, an owner or investor.
- **Property Management Agreement.** A formal contract that specifies actions taken during the ownership or operating period which are taken to ensure that a property is adequately maintained and serviced. The contract focuses on daily operations including cleaning, utility charges, routine repairs, security, tenant calls and other on-going obligations.
- **Service Agreement(s).** Contract specifying the provision of various professional and personal services that are provided by a third party



under a contractual obligation. These services are typically outsourced, looking to an external service provider rather than being performed internally.

- **Standard Operating Procedures Statement.** An agreement that establishes a set of procedures that specify the normal standards of practice for a particular type of activity or procedure.
- **Tenant Relation Agreement.** A document that guides the management of the relationship between landlord and tenants and among tenants. The objective of this agreement is to help create and maintain an environment that is synergistic and helps maximize productivity of the overall center and individual tenants.
- **Unilateral Contract.** A contract presumed by one party that is not binding on the other party unless that party accepts the contract by virtue of its subsequent performance of terms of the contract. This could occur when some contract is not formally extended by the service provider continues to render services that are accepted by the other party.

Operating Finance Contracts

- **Carve-Out Finance Agreements.** With respect to a mortgage, the contract can be invoked when a lender specifies certain items for which a developer/borrower will be personally liable even though the overall loan will be treated as non-recourse debt.
- **Modification and Assumption Agreement.** A mortgage agreement that is written when a due-on-sale clause is triggered by a sale of an underlying property and the parties pursue an assumption of the mortgage with existing terms by a new borrower. In most cases, the agreement will result in a release of the initial borrower from on-going responsibility and substitute the new borrower.
- **Mortgage Pledge Agreement.** The concurrent agreement attached to the permanent loan note which pledges specified real estate interests as collateral and establishes any other conditions or restrictions necessary to protect the collateral value.
- **Mortgage Servicing Agreement.** A contract that defines the terms of management of outstanding mortgages. It addresses such functions as collection, distribution of funds, recording and management and distribution of escrow funds. It also addresses the management delinquencies and oversight of foreclosures for the benefit of investor or client.
- **Permanent Loan Note.** A promissory note specifying the repayment and other activities, terms or conditions associated with a permanent mortgage.
- **Personal or Corporate Guarantees.** The pledge of an individual or company to backstop some financial agreement in the event of a default by a third party.



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Disposition Stage

- **Assignment Agreement.** A formal agreement that documents the conditions under which property rights, mortgages and/or rent collections can be transferred from one party to another and the approvals or consent that is required to ensure such a transfer is legal and binding. The agreement also addresses the release or transfer of liability to another party.
- **Carve-Out Sales Agreements.** On the ownership front carve-out agreements may be used to describe situations in which minority stakes or interests are sold in the market, thus reducing the residual ownership
- **Exclusive Listing Agreement.** This contract grants a broker the exclusive right to sell the property under specified conditions. If the property sells as a result of the actions of any third party other than the seller, vendor, or the broker is still entitled to the commission.
- **Hold-Harmless Agreement.** A contract by which a party waives future rights to pursue claims against another party; a form of a release.
- **Listing Agreement.** A formal document or agreement between an owner and broker that specifies the rules of engagement or rights and responsibilities of the two parties. In general, the contract delegates the authority to present a specified property to the broader market in hopes of attracting a buyer and consummating a transaction.
- **Satisfaction of Mortgage Agreement.** If there is an outstanding permanent loan, a loan satisfaction agreement will be tendered simultaneously with the closing that transfers interest to a third party. This satisfaction agreement will be necessary to ensure the new owner and/or lenders can assume a first lien position on the property.
- **Sales Contract.** This is the formal document which transfers the interests in real estate to a third party. The contract is in writing and contains the terms and conditions under which the title and/or other interests are being transferred. It also addresses any residual claims and the form of deed or interest that certifies what is being transferred and any claims or representations that are being made at closing.
 - **Purchase Contract.** A formal written document that transfers ownership interest subject to the completion of certain requirements regarding economic performance. The title remains with the seller until such items are satisfied.
 - **Release Agreement.** A formal waiver of any rights associated with a prior contract or agreement.
 - **Termination Agreement(s).** Contracts that release parties from on-going business and/or related claims.



Summary Chapter 5

- **Legal Dimensions of Real Estate.** Real estate is one of the more complex asset classes in terms of legal rights.
- **Legal Descriptions.** In order to support real estate transactions, properties must be capable of being clearly and unambiguously delineated. There are a number of approaches to legal descriptions including those derived from new technological innovations including GPS and GIS.
- **Condominiums, cooperatives and timeshares.** Special forms of ownership require special definitions to identify the underlying interests.
- **Bundle of Rights.** Real estate parcels have bundles of rights; possession, use, enjoyment and transfer. These rights may be separated and transferred to third parties making it critically important to understand what portion of the bundle is associated with a particular ownership interest.
- **Estates.** There are two types of estates in real estate: freehold estates which control the bulk of the bundle of rights, and leasehold estates which control rights for a period of time.
- **Non-possessory Interests.** Real estate rights can be vested with third parties who despite not being in possession of real estate may have a significant impact on the use and enjoyment by others. These interests include easements, restrictive covenants
- **Liens.** Third party claims against real estate can have a material impact on the residual value that ownership interests represent after they are resolved. Since they are enforceable, they should be reviewed and included in any valuations.
- **Role of Leases.** When evaluating commercial real estate, one is buying a set of assumptions about the current and future conditions with respect to the individual asset and the market within which it resides. Leases play a critical role in helping evaluate those assumptions.
- **Covenants.** Leases tend to follow a standard form for many covenants, but then can easily diverge into a unique set of legal rights and requirements. It is critical that these rights be understood and priced into the asset.
- **Contracts.** The real estate industry is highly dependent on contracts. These contracts are pervasive, covering the full spectrum of the product life cycle including: planning, acquisition/development, operation and disposition.

Concepts

- Metes & Bounds
- Government Survey Method
- Freehold Estates
- Less-than-Freehold Estates
- Bundle of Rights
- Leasehold Estates
- Scenic Easements
- Restrictive Covenants
- Liens
- Lease Requirements
- Lease Covenants
- Lease Economics
- Ground Leases
- Planning Contracts
- Acquisition Contracts
- Architectural Contracts
- Construction Contracts
- Financial Contracts
- Operational Contracts
- Disposition Contracts

Bundle of Rights. Real estate ownership contains a bundle of rights including possession, use, enjoyment and transfer. These rights can be separated from the real estate and transferred to third parties. Thus, it is important to understand which portion of the bundle of rights is associated with a particular claim on the asset.



Section 2: Chapter Next