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# Landmarks

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## Crowdfunding—What It Is, What to Watch

Barry J. Guttman

Crowdfunding became one of the most talked about ways of raising capital for commercial real estate (CRE) transactions following its legalization by the JOBS Act in 2012. But what exactly is crowdfunding, and what do CRE developers, lenders and investors—as well as crowdfunding companies considering investment in CRE—need to know when evaluating crowdfunded CRE projects?

In the CRE context right now, the term "crowdfunding" generally refers to raising capital by publicly soliciting investments from a large number of accredited investors, usually via an online platform. Typically, a prospective investor logs onto the platform and, after representing that he or she qualifies as an accredited investor, is granted access to the platform's listings of potential CRE investments. (Accredited investors are defined in SEC Rule 501 of Regulation D, but generally, they are either commercial entities or high-net-worth individuals.) An interested investor will then commit capital toward the purchase of a specific property. The platform will then pool the investments, which may include capital from the platform itself, and package them into a single or special purpose entity (SPE) that will acquire or invest in the property.

However, other crowdfunding mechanisms exist. For example, platforms may also act solely as a broker/dealer to sell investments in third-party investments or operate on a subscription basis and simply allow subscribing companies and investors to connect with one another and negotiate their own terms of investment. Each of these structures raises distinct issues for crowdfunding platforms and CRE developers, lenders and investors. Some of these issues are highlighted below.

**Concerns for Crowdfunding Platforms Considering CRE Investments**

Crowdfunding platforms are structured pursuant to SEC rules. Many CRE crowdfunding platforms structure their offerings under Title II of the JOBS Act, specifically SEC Rule 506(c) of Regulation D, because it has more relaxed requirements than Title III of the JOBS Act (the other statutory authorization for crowdfunding). However, even Rule 506(c) has a web of restrictions that crowdfunding platforms must navigate. For example, Rule 506(c) limits the number of investors who can invest in a particular project, a limitation that the platform's investment structure must take into account. Rule 506(c) also contains limits on compensation for platforms, as well as the amounts of investments that can be made. These are all particularly concerning for large CRE projects.

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State-level restrictions may also apply to crowdfunding platforms. States may require licensing for originating, brokering and servicing loans and other investments. States may also have record-keeping, surety bonds, minimum net worth and reporting requirements. State securities laws may also require registration and adequate disclosure of downside risk, among other requirements. CRE crowdfunding platforms must take care to comply with state restrictions in not only the state in which the crowdfunding company is domiciled but also the states where investors and properties are located.

### Concerns for CRE Developers Considering Crowdfunding

If a CRE developer elects to directly engage in crowdfunding, then the developer will need to comply with all the requirements for crowdfunding platforms, some of which were discussed above. However, if a CRE developer is not engaging directly in the crowdfunding and instead seeks to use a third-party platform to raise capital, then the developer will need to negotiate several issues with that platform. How will the developer structure its venture to account for the crowdfunded SPE? What priority will the crowdfunded SPE's investment have, and how will that affect the project's capital stack? Will the developer have any obligations to the crowdfunded SPE's investors directly, or only through the crowdfunding platform? What kinds of disclosure or due diligence requirements will the developer have vis-à-vis the crowdfunded SPE and/or the crowdfunded SPE's investors, and who will bear any associated costs? How much control will the crowdfunded SPE seek to exercise over changes in construction plans? What levels of control do the investors have over the crowdfunded SPE, and will granting the crowdfunded SPE control over certain decisions effectively grant the crowdfunded SPE's investors control over those decisions? How is the developer protected against the platform's failure, bankruptcy or dissolution? These are just some of the issues CRE developers face when considering whether or not to use crowdfunding in raising capital for CRE projects.

### Concerns for CRE Lenders and Investors Considering Crowdfunding

CRE lenders and investors considering crowdfunding face numerous issues, including the following:

1. What will be the nature and priority of the investors' or lenders' security interest, if any, in the property? Lenders likely will not accept anything but the highest security interest available, so if investors want a security interest, then they may need to accept a second priority lien or a lien on equity interests as opposed to property interests. Investors also need to understand the priority of their interests relative to other investors in the crowdfunded SPE, when they will be paid distributions by the developer and/or the SPE, and their rights in an event of default.

2. How well is the platform capitalized? Are there any institutional investors supporting the platform? Has the platform diversified its investment portfolio? Investors face additional risk if a platform is undercapitalized because the investment may be more likely to fail. The presence of institutional investors may provide some comfort, but absent true diversity in the platform's portfolio, investors may be wary of committing their money.

3. What due diligence is being provided regarding the property and the platform? Is the platform itself investing in the property? A platform investing its own capital into the project is more likely to have done more due diligence on the property and expended more effort negotiating its terms with the developer, so investors investing in such a project may be able to rely more on the platform's due diligence.

4. Is there a time gap between closing the crowdfunding phase and closing on the real estate investment? If so, then investors need to negotiate their rights and responsibilities during that time, including who will hold their money.

### The Bottom Line

CRE crowdfunding is a rapidly growing area of CRE finance that provides exciting opportunities for crowdfunding platforms, developers, lenders and investors. However, for reasons like those described above, top-tier counsel is critical for anyone considering crowdfunding in the CRE context. Further, the SEC is currently evaluating proposed rules for crowdfunding by non-accredited investors, which will undoubtedly not only open more CRE opportunities, but also contain new restrictions. We at Benesch will keep you up to date with the latest CRE crowdfunding news.

For more information, please contact **BARRY J. GUTTMAN** at bguttman@beneschlaw.com or 216.363.4547.

**DOUGLAS E. HAAS** and **KELLY M. KOZICH** provided background and research assistance on this article.

# Spotlight on Insurance: Know the Risks Involved with the Protective Safeguards Endorsement

Christian F. Moratschek

Many property owners and managers in the commercial real estate industry are aware that in exchange for maintaining certain protective safeguards at a commercial property (e.g., fire suppression systems, security systems, etc.), a property owner is afforded certain discounts on its property insurance. In exchange for the provision of such discounts, insurers typically require that the "Protective Safeguards Endorsement" be added to the policy (ISO Form IL 04 15 04 98). What many property owners and managers are unaware of, however, are the requirements that the foregoing endorsement imposes upon the insured, and the substantial risk that results in failing to comply with such requirements.

The protective safeguards endorsement provides that the insurer will not pay for loss or damage caused by or resulting from fire if, prior to the fire, the insured:

1. Knew of any suspension or impairment in any protective safeguard listed in the endorsement and failed to notify the insurer of that fact; or
2. Failed to maintain any protective safeguard listed in the endorsement, and over which the insured had control, in complete working order.

The protective safeguards endorsement does provide a limited safe harbor in that it also states "[i]f part of an Automatic Sprinkler System is shut off due to breakage, leakage, freezing conditions or opening of sprinkler heads, notification to [the insurer] will not be necessary if you can restore full protection within 48 hours."

The language that is most troubling and concerning from an insured's perspective is the language within the endorsement providing that the insurer will **not** pay for loss or damage if the insured does not comply with its obligations as set forth above.

To demonstrate how this issue could arise in the real world, let's assume a property owner leases all or a portion of its property to a tenant pursuant to a commercial lease. Let's further assume that the landlord's property insurance policy contains a protective safeguards endorsement, and that the commercial lease agreement contains a provision permitting the tenant to make interior nonstructural alterations, provided such alterations do not materially adversely affect building systems and notice is provided to the landlord. Such provisions, although common, can pose significant risks to a landlord.

Consider the following example. The tenant under our scenario remodels the interior of its premises to create two new office spaces. In doing so, the tenant's contractor temporarily shuts off only the portion of the building's fire suppression system running through the leased premises for approximately four days while certain work is being performed in connection with the remodel. The tenant notifies the landlord of its renovation plans, but the landlord is unaware of its obligation to notify its insurer that a portion of the sprinkler system will be shut off for approximately four days. Now assume a fire breaks out at the building and results in a complete loss of the building. Under the facts of the foregoing scenario, the landlord's insurer could very well deny coverage of the fire loss due to the failure of the landlord to comply with the requirements imposed by the protective safeguards endorsement.

Scenarios not unlike the one above have played out in court, with the landlord often on the losing end. For example, in *Burmac Metal Finishing Co. v. West Bend Mutual Insurance Co.*, a 2005 Illinois appellate court case, it was found that a property owner's intentional capping of somewhere between 3 and 19 automatic sprinkler system heads out of 600 in an industrial building, without notice to the insurer, constituted a failure to maintain the fire suppression system and justified a denial of coverage for a fire.

So how do you avoid such a harsh result? Below are some practical considerations to be mindful of:

- A determination should be made whether the premium discount associated with the protective safeguards endorsement is worth the extra risk involved.
- The form of lease should be reviewed to determine if lease provisions regarding tenant alterations should be amended to allow more landlord involvement and control in connection with any such alterations. In certain instances it may be worth setting forth in the lease an acknowledgment by the tenant that the protective safeguards endorsement is attached to the landlord's property insurance policy, and spell out the additional obligations imposed by such endorsement and include appropriate indemnity language.
- Keep detailed records with respect to all maintenance, repairs and replacements undertaken in connection with all protective safeguards.
- Review and be aware of the notice provisions under all applicable insurance policies.

For more information, please contact **CHRISTIAN F. MORATSCHEK** at cmoratschek@beneschlaw.com or 216.363.4679.

## Get to Know **James H. Schwarz**

James H. Schwarz

**Who: James H. Schwarz** is a partner with the firm's Real Estate & Environmental Practice Group. He has acted as developer's counsel in connection with the development and financing of the largest shopping mall in the United States, the Mall of America. Jim has represented real estate developers in the acquisition, development, financing, leasing and sale of real estate.

**What Jim wants you to know about the real estate industry:** The real estate market is busy today for those who have access to capital.

**What Jim is be doing when he isn't practicing law:** When I am not practicing law I am playing tennis and watching sports or traveling the globe.

**Jim's favorite hobby:** I like to play tennis (so long as my body holds up) and I enjoy reading spy novels.

**The best thing about being a real estate attorney:** You get to work with really smart people and get to see the fruits of your labor.

**Jim's favorite thing about living and working in Indy:** I like the Midwestern values and the ability to live in a city with lots of "big town" attractions but with a "smaller town" vibe.

# Reinvestment In Leased Retail Space—Top 10 Legal Considerations

Norman W. Gutmacher

There are a number of business and legal issues a store owner should take into consideration when reinvesting in a leased store location to keep it fresh, current and competitive. The following is a list of the "Top 10" legal issues to consider:

1. **Does the lease permit the remodeling or alteration of the leased store location without the landlord's consent?** If not, be sure to obtain written consent from your landlord before moving forward.
2. **Does the existing term of the lease, including any existing rights to extend or renew, provide adequate time to recoup the financial investment over the remaining term of the lease?** If not, consider negotiating a lease extension before moving forward.
3. **Does the lease permit the right to grant a lender a "leasehold mortgage"?** If it is necessary to borrow funds to finance a reinvestment, the lender may require a "leasehold mortgage" on your leased store location as security for the loan. If the lease does not permit a leasehold mortgage, be sure to obtain written consent from the landlord before moving forward.
4. **Is evidence of the lease on record?** Recordation of evidence of the lease with the recorder of the county where the leased store is located is imperative to protect the tenant's rights under the lease against unrelated third parties. Further, in some states, the validity of an unrecorded lease may be challenged. Before reinvesting, evidence of the lease should be recorded.
5. **Does the landlord have any mortgages on the leased store location?** If so, consider obtaining a "non-disturbance" agreement from each holder of a mortgage to protect the tenant's rights under the lease in the event the landlord should default on its mortgages.
6. **Has the construction contract been carefully reviewed and negotiated?** Keep in mind, there is no such thing as "boilerplate." Everything is negotiable.
7. **Has an architect been engaged to confirm that the plans and specifications comply with applicable laws?** The failure to comply with applicable laws, including the Americans with Disabilities Act, can be costly. Compliance should be determined prior to commencing any remodeling.
8. **Is your lease working and/or could it be better?** Before reinvesting, there may be an opportunity to negotiate new terms with the landlord to better protect your investment. Consider attempting to negotiate "exclusive" rights, protections against key tenant closures, and "sight line" protections.
9. **Does the lease comply with the applicable jurisdiction's execution requirements?** A lease that is not properly executed in compliance with applicable state laws may not be valid. Prior to reinvesting in your space, consider remedying any execution issues by properly executing an amendment.
10. **Is your current insurance coverage adequate to cover the reinvestment?** By reinvesting, the leased store location will increase in value. Confirm with the insurance carrier that the existing policy covers the reinvestment in the event of a fire or other casualty.

For more information, please contact **NORMAN W. GUTMACHER** at ngutmacher@beneschlaw.com or 216.363.4591.

# What to Know About Subleasing

Christian F. Moratschek

In a sublease, the tenant, acting as a landlord, leases some or all of its interest in the leased premises to the subtenant, but the tenant retains an interest in the premises. That interest may be continued possession of a portion of the premises, or a reversionary interest in the premises.

**Why Sublease?**

A sublease offers more flexibility than an assignment and can be adapted to a number of situations. For example:

- You can sublease less than all of the premises. A tenant may not need all of its leased space and may desire to cover some of its rental expense for the unused space. The tenant can continue to use the balance of its leased premises under the terms of its lease.
- A sublease term can be shorter than the balance of the prime lease term.
- Sublease rent can be at a different rental rate. Under some circumstances, the rental market may be such that the tenant can sublease the space for a rental amount greater than that which is being charged under the lease. Conversely, if a tenant is motivated to sublease unneeded space to cover its costs, the subtenant may be able to rent the space at a rental rate lower than current market rates.

Set forth below are a number of items to consider prior to entering into a sublease, whether as a landlord or as a tenant.

**Due Diligence on the Prime Lease**

In addition to its investigation of proposed sublease space, the subtenant must do some basic due diligence on the prime lease at the start of the process. The subtenant must obtain and review a complete copy of the prime lease, together with all amendments and modifications and all other documents, rent commencement letters, tenant estoppel certificates and the like that may affect the prime lease and the rights of the tenant. The subtenant must determine whether the terms and conditions of the prime lease are acceptable for the subtenant's purposes and whether the tenant will be able to sublease the premises on terms and conditions acceptable to the subtenant. The subtenant should further consider what conditions it should impose on the effectiveness of the sublease (e.g., obtaining the landlord's consent [if necessary] by a stated deadline, requiring that any nondisturbance agreements from the landlord or landlord's lender be obtained, etc.).

**Practical Issues**

There are a number of practical issues to consider prior to entering into a sublease arrangement. The parties must consider whether these various issues can be handled practically and economically and at whose expense. For example, when the subtenant is taking less than all of the leased premises, there may be issues concerning the separation of the tenant's retained space from the sublease space. There may also be questions of security, separation or submetering (or allocation) of utilities, control of HVAC, sound attenuation, etc. With office space, there may be issues concerning shared amenities such as reception areas, conference rooms and the like.

**Protecting the Landlord**

The landlord may want to protect itself from claims by the subtenant and confirm certain facts and legal rights by use of a Sublease Consent Agreement. A Sublease Consent Agreement can address issues of concern to the landlord.

**Preserving the Sublease**

To protect the subtenant's interest in the event of a termination of the prime lease by the landlord (e.g., a termination after tenant defaults or goes into bankruptcy), the subtenant can enter into a nondisturbance agreement (or sublease recognition agreement) with the landlord. The subtenant needs to be clear, however, as to what terms will apply in the event that the nondisturbance agreement becomes effective. Will the subtenant be governed by the terms of the sublease or by the terms of the prime lease?

**Incorporating the Prime Lease by Reference**

A common practice in drafting subleases is to incorporate the terms of the prime lease into the sublease. This can be a dangerous practice that inadvertently imposes unintended obligations and liabilities on the parties. When drafting a sublease, the parties must be thoughtful as to which provisions are appropriate to incorporate by reference and which are not.

**Enforcement of Landlord's Obligations**

The subtenant will expect to receive the benefit of the performance of the landlord's obligations under the prime lease. Those obligations may include certain building services or amenities, maintenance of the building and premises, and restoration in the event of a casualty. However, since the subtenant does not have a contractual relationship with the landlord, the subtenant has no means of enforcing the landlord's obligations. This issue is addressed in subleases by requiring the tenant to enforce the landlord's obligations on behalf of the subtenant.

**Time Periods**

When drafting the sublease, the parties should be careful about the time periods for performance of their obligations and cure periods. Where the tenant's obligations under the prime lease are passed through to the subtenant, the subtenant must perform those obligations within a time period that avoids a default under the prime lease. If the sublease requires the tenant to take action to enforce performance of the landlord's obligations under the prime lease after some notice from the subtenant, then the period of time permitted for the tenant's action needs to be longer than the cure period given to the landlord under the prime lease.

**Surrender of the Premises**

The surrender provisions of the prime lease and the sublease may contain pitfalls that are easily overlooked. If the subtenant assumes the tenant's obligation to return the premises to the landlord in the condition that they were in at the beginning of the prime lease term, the subtenant may be taking on a substantial demolition/restoration expense that it did not intend. Similarly, if the subtenant performs a substantial build-out of the premises, and the sublease does not require the subtenant to return the premises to their prior condition, then the tenant may unexpectedly have to bear the demolition/restoration expense.

**Conclusion**

Drafting a sublease (even a short one) is a complex exercise of analyzing the prime lease and the intended sublease terms and appropriately allocating risks and responsibilities of the tenant and subtenant.

For more information, please contact **CHRISTIAN F. MORATSCHEK** at cmoratschek@beneschlaw.com or 216.363.4679.

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# RECENT TRANSACTIONS

- Represented the purchaser of a 260-unit apartment complex in Ohio. The purchaser retained Benesch after having been the winning bidder in an auction and had to close the purchase (including satisfying the requirements of a CMBS lender) in 30 days.
- Representing Stark Enterprises in the acquisition and development of the nuCLEus Development Project, a transformational project for downtown Cleveland. The development will have commercial critical mass of almost 150,000 SF of national restaurant and retail tenants, 500 apartment units, 200,000 SF of executive office space and nearly 1,500 parking spaces.
- Represented a publicly traded REIT in the review and analysis of due diligence in connection with the $1.93 billion acquisition of a 71 shopping center multi-state portfolio.
- Representing a developer of affordable and market rate multifamily housing in connection with the acquisition of a 9 property multistate portfolio located in the southeastern United States.
- Representing a developer of affordable and market rate multifamily housing in connection with the acquisition of an approximately $46 million, nine-property portfolio located in the eastern United States, including the assumption of existing HUD indebtedness on all such properties.
- Represented a publicly traded REIT in the $223 million sale of a three-shopping-center portfolio located in greater Salt Lake City, Utah.
- Represented an owner and manager of shopping centers in connection with the $29 million acquisition of a 426,000 SF power center located in Southern Ohio.
- Represented the lender in closing a $20+ million construction loan for a multifamily apartment project outside Houston, TX.
- Represented the lender in closing a $20+ million construction loan for a warehouse and distribution facility outside Nashville, TN.
- Represented a real estate investor in connection with the acquisition of a flagged hotel in Florida, utilizing CMBS financing.
- Represented a lender in connection with a construction and mini-permanent loan to a catholic school in New Castle County, Delaware.
- Represented a lender in connection a $17 million construction loan for an apartment project in New Castle County, Delaware.
- Represented a not-for-profit organization in connection with a $10.5 million construction loan for the initial phase of a mixed-use development along the Chesapeake and Delaware Canal in Delaware.
- Represented a lender in connection with a construction loan for a mixed-use center in Baltimore County, Maryland.
- Represented a lender in connection with over $20 million in credit facilities for a hotel/condo project in Sussex County, Delaware.

# Real Estate & Environmental Group

**For more information about our Real Estate & Environmental Practice Group, please contact any of the following:**


JEFFREY J. WILD, Chair | (216) 363-4544
jwild@beneschlaw.com

JEFFREY A. ABRAMS | (317) 632-0370
jabrams@beneschlaw.com

JOY A. BARRIST | (302) 442-7005
jbarrist@beneschlaw.com

KIAMESHA-SYLVIA G. COLOM | (317) 685-6163
kcolom@beneschlaw.com

CHRIS L. CONNELLY | (614) 223-9317
cconnelly@beneschlaw.com

TAMAR GONTOVNIK | (216) 363-4658
tgontovnik@beneschlaw.com

NORMAN W. GUTMACHER | (216) 363-4591
ngutmacher@beneschlaw.com

BARRY J. GUTTMAN | (216) 363-4547
bguttman@beneschlaw.com

ANDREW A. KLEIMAN | (317) 685-6139
akleiman@beneschlaw.com

LEE KORLAND | (216) 363-4189
lkorland@beneschlaw.com

DAVID MANSBERY, JR. | (216) 363-4637
dmansbery@beneschlaw.com

KEVIN MARGOLIS | (216) 363-4161
kmargolis@beneschlaw.com

MADELINE T. McGRANE | (216) 363-4419
mmcgrane@beneschlaw.com

CHRISTIAN F. MORATSCHEK | (216) 363-4679
cmoratschek@beneschlaw.com

NORMAN R. NEWMAN | (317) 685-6141
nnewman@beneschlaw.com

ROBERT C. ONDAK, JR. | (216) 363-4533
rondak@beneschlaw.com

ADAM N. SAURWEIN | (216) 363-4462
asaurwein@beneschlaw.com

JAMES H. SCHWARZ | (317) 685-6127
jschwarz@beneschlaw.com

HOWARD A. STEINDLER | (216) 363-4560
hsteindler@beneschlaw.com

MICHAEL K. SWEARENGEN | (216) 363-6139
mswearengen@beneschlaw.com


# NEWS ABOUT US

- Benesch Real Estate attorneys, **JEFF ABRAMS, NORMAN GUTMACHER, JIM SCHWARZ, HOWARD STEINDLER** and **JEFF WILD** were named "Leaders in Their Field" by the 2014 edition of *Chambers USA*. **JOY BARRIST** was named as an "Up and Coming" attorney for Real Estate Law in Delaware.
- **BENESCH WAS RANKED IN THE FIRST TIER IN REAL ESTATE LAW** in Cleveland, OH, and Indianapolis, IN, by the 2015 U.S. News/Best Lawyers® "Best Law Firms" rankings.
- **JOY BARRIST** was appointed to the Mortgage Lending Committee of the American Bar Association (ABA). The Mortgage Lending Committee is a subcommittee of the Real Estate Financing Group of the ABA Section of Real Property Trust and Estate Law.
- **MADELINE MCGRANE** was named President-elect of the Commercial Real Estate Women's Inc. (CREW) of Cleveland for 2015.
- **JEFF ABRAMS** just finished his term as the 2014 President of the Indianapolis Bar Association (IndyBar). IndyBar is a group of approximately 5,000 attorney, judicial, paralegal and law student members who make up the core of the central Indiana legal community. Jeff led a governing board of 29 directors this year, establishing the direction and overseeing the goals of the organization as a whole.