In the Zone

Fox Rothschild LLP
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Good Guys Beware: Five Things You Need To Know About "Bad Boy" Guaranties Before You Sign the Term Sheet

By Lauren W. Taylor

Oftentimes, when negotiating a non-recourse loan, the term sheet will provide that the loan will be secured by the lender's standard "bad boy" guaranty. But what does this mean? In most cases, it includes a much wider range of acts than you would think. What was once a relatively short and simple list of bad acts has become a complex laundry list that can quickly turn your non-recourse loan into a full recourse loan.

Because of the intricacies in the wording of bad boy guaranties, it is important for guarantors to understand the scope of the lender's proposed bad boy guaranty before signing the term sheet. The following is a highlight of just a few of the things to look out for before agreeing to a bad boy guaranty:

1. **Know What Carve-Outs Trigger Liability for the Full Loan Amount**
   Most bad boy guaranties have two tiers of carve-outs: those acts that trigger liability for only the actual losses that are incurred by the lender as a result of the bad act and those acts that trigger liability for the entire amount of the loan. Guarantors should try to negotiate the terms of the guaranty to provide that most of the bad boy acts will only cause the guarantor to become liable for the lender's actual losses (i.e., failure to pay taxes, violation of environmental laws and misapplication of insurance proceeds, condemnation awards or gross revenues). Acts that result in liability for the full amount of the loan should be limited to only the most egregious acts.
2. **Limit Bad Boy Acts to Acts by the Borrower and Guarantor – Not Third Parties**
   Acts by third parties should not trigger liability under a bad boy guaranty. For example, while a voluntary bankruptcy filing may be considered, by some lenders, to be a bad boy act, a borrower cannot control involuntary bankruptcy filings against it and so an involuntary bankruptcy should not trigger liability under a bad boy guaranty. Similarly, guarantors should try to exclude terminations of leases by tenants and environmental issues caused by other persons from the list of events constituting bad boy acts.
3. **Thoroughly Review Single Purpose Entity Covenants**
   Lenders typically include breaches by borrowers of their single purpose entity (SPE) covenants as bad boy acts. Guarantors should carefully review each SPE covenant to determine whether it makes sense for a breach of such covenant to trigger liability under the bad boy guaranty. SPE covenants can range from prohibitions on the dissolution, merger and sale of assets by the borrower to requiring the borrower to use separate letterhead. Clearly, a guarantor's liability under the bad boy guaranty should not be triggered merely by the borrower's failure to use separate letterhead.
4. **Watch Out for Requirements That the Borrower Remain Solvent**
   Requirements that the borrower remain solvent are usually buried in the loan documents within a SPE covenant. As discussed above, violations of SPE covenants often trigger liability under bad boy guaranties. So if the borrower does not remain solvent, then the guarantor becomes liable. The whole point of a non-recourse loan is to limit the borrower's liability to the mortgaged property if it becomes insolvent, so guarantors must pay special attention to the non-recourse carve-outs relating to solvency. Some states have passed legislation to protect guarantors from liability resulting from these covenants by prohibiting triggers based on "post-closing solvency covenants" on the basis that they are against public policy, but until this becomes the practice in all states, guarantors need to be aware of this trigger.
5. **Request Notice and Cure Rights**
   Guarantors should try to obtain notice and cure rights before they can be subject to personal liability under a bad boy guaranty. This is particularly important if the bad boy acts trigger liability for the full amount of the loan. Hopefully you will be able to successfully negotiate that most bad boy acts will only result in liability for the lender's actual losses. But, if that is not the case and your liability for the entire amount of the loan can be triggered by a curable event (such as a mechanic's lien filing), then you should have the opportunity to cure the default.

Because the scope of bad boy acts will vary from lender to lender, guarantors should request to see a copy of their lender's standard bad boy guaranty, and have it reviewed by their attorney, early in the loan negotiations when they will have the most leverage, particularly before giving the lender a "six figure" deposit check!

In This Issue:

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The Need for Off-Site Stormwater Easements in Pennsylvania

By Robert W. Gundlach, Jr.

It is not uncommon these days for a question to arise as to the need for an off-site stormwater easement by the municipality or Department of Environmental Protection (DEP) as part of the design of the stormwater system for a new development project. When this happens, an applicant needs to determine if they can redesign their stormwater system to avoid the need for this off-site stormwater easement or if they will have to approach one or more adjacent or area landowners to acquire a stormwater easement on their properties. Obviously, in many cases, the former is much easier than the latter; particularly when one of those landowners from whom you would need a stormwater easement is either opposing your project or looking for a payday. And I am not talking about the candy bar.

In the recent case of *Bretz v. Central Bucks School District*, the Commonwealth Court attempted to "clarify" the law as to when an applicant needs an off-site stormwater easement. Unfortunately, based on my reading of this case, the Court only "muddied up the waters" on this subject. Some might attempt to argue that the *Bretz* case sets a "new and higher" standard as to when an applicant needs an off-site stormwater easement. Some might also attempt to argue that an off-site stormwater easement is now needed any time an applicant has proposed to construct a stormwater basin and discharge the water from the basin either directly or indirectly onto an adjacent property. In my opinion, such an interpretation would further complicate and frustrate the approval process when it comes to stormwater designs and would be contrary to the intent of the Pennsylvania Stormwater Management Act and other DEP regulations/design guidelines on the subject.

In *Bretz*, the adjacent landowner appealed an Order of the Bucks County Court of Common Pleas that denied their request for injunctive relief concerning stormwater issues they were having as a result of recent and proposed improvements by the adjacent Central Bucks School District. The landowner's 31-acre property is downstream from and adjacent to the District's 66-acre property containing a high school, middle school and related improvements. The landowner filed a complaint in equity alleging that the expansion of the adjacent schools caused an increase in the volume and duration of stormwater discharge onto their property and resulted in long-term and continuous damage to their property. According to the landowner, the detention basin, berm and 36-inch pipe installed by the District operated to decrease the rate of surface water flow onto their property, but substantially increased the duration of stormwater discharge from one to four or five days.

At the hearing before the lower court, both parties presented expert testimony concerning the stormwater management undertaking during the District's construction. Much of the testimony concerned whether the District violated the applicable subdivision and land development ordinance. However, all parties agreed that, although the direction of water into the new detention basin decreased the rate of stormwater flow onto the landowner's property, it increased the total volume of water discharged. The trial court determined that the landowner was not entitled to injunctive relief because they failed to establish a violation of the Township's subdivision and land development ordinance; and because the continued construction of the District's improvements will, in the future, reduce stormwater flow onto their property to pre-development levels.

On appeal, the landowner argued that the trial court erred in holding that the landowner did not demonstrate an exception to the "common enemy rule" (i.e., the general principle that the law regards surface waters as a common enemy which every proprietor must fight to get rid of best he may) in determining that the District did not violate the applicable SALDO provisions and that the District's construction of a stormwater detention basin and a 36-inch pipe did not constitute an alteration of existing points, patterns or the location of natural drainage.

In order to understand this issue, a historical review as to prior case law on the subject would be helpful. In 1906, in a case titled *Strauss v. Allentown,* the Pennsylvania Supreme Court held as follows:

> The owner of upper land has the right to have surface waters flowing on or over his land discharged through a natural water course onto the land of another . . . He may take proper and profitable use of his land even though such use may result in some change in quality or quantity of the water flowing to the lower land . . . from those rules it is clear that only where the water id diverted from its natural channel *or* where it is unreasonably or unnecessarily changed in quantity or quality has the land owner received an injury.

In 1955, the Supreme Court restated the common enemy rule in the case of *Leiper v. Heywood-Hall Construction Co.*, as follows:

> It is only where the owner of higher land is guilty of negligence which causes unnecessary damage to the servient owner, *or where by an artificial channel, he collects and discharges surface waters in a body* or precipitates them in greatly increased quantities upon his neighbor, that the latter may recover for any damage thereby inflicted.

In this same case, the Supreme Court summarized the law on this subject as follows:

> A landowner *may not alter the natural flow of surface water on his property by concentrating it in an artificial channel and discharging it upon the lower land of his neighbor even though no more water is thereby collected than would naturally have flowed upon the neighbor's land in a diffused condition*. One may make improvements upon his own land, especially in the development of urban property, grade it and build upon it, without liability for any incidental effect upon adjoining property even though there may result some additional flow of surface water thereon through a natural watercourse *but he may not, by artificial means, gather the water into a body and precipitate it on his neighbor's property*.

In *Marlowe v. Lehigh Township*, in 1982, the Commonwealth Court, in reliance on the above authority, held that where surface water is artificially diverted or collected, a plaintiff sustains a cognizable injury if there has been an increase in the total volume of water discharged onto the land or if the volume remains unchanged but is "discharged with augmented force." This Court also held that the legal wrong lies in the artificial diversion or collection of water itself, and made these pronouncements without regard to the degree in which the volume or force is increased per this Court: "A plaintiff need only show that a landowner collected and/or concentrated surface water from its natural channel through an artificial medium, and the water was discharged onto the plaintiff's property in an increased volume or force; however slight."

Then, in 1985, these principles were summary by the Superior Court in *LaForm v. Bethlehem Township*, which held that an upper landowner is liable for the effects of surface water running off his property in two distinct circumstances: (1) where the landowner has diverted the water from its natural channel by artificial means; or (2) where the landowner has unreasonably or unnecessarily increased the quantity or changed the quality of water discharged upon his neighbor.

In the *Bretz* case, in addressing the District's liability under the common enemy rule, the trial court determined that the increase in quantity of water was "reasonable," the installation of the detention basin and 36-inch pipe was "a proper and profitable use" of the District's land, and the water was discharged onto the landowner's property at the same place before and after construction. However, the Commonwealth Court held that the trial court applied only the second standard set forth in *LaForm* (unreasonable or unnecessary change in quantity or quality), and overlooked the first standard (diversion from the natural channel by artificial means).

Per the Commonwealth Court, the determination of whether a landowner "has diverted the water from its natural channel by artificial means" does not involve consideration of the reasonableness of the change in quantity or location of water flowing onto the lower land; rather, to establish liability, a plaintiff need only show that a landowner collected and/or concentrated surface water from its natural channel through an artificial medium and that the water was discharged onto plaintiff's property in an increased volume or force; however, slight.

In this case, the trial court specifically found the following as fact:

- The natural, physical contour leading to the landowner's property was a 60-foot-wide swale. Due to the District's construction, the swale was replaced by a five to six-acre detention basin and a surrounding 15-foot high berm.
- The detention basin and berm collected additional surface water emanating from five to seven acres (and after the science wing measures two to four acres) of drainage area, which was diverted toward the Landowner's property as a result of the District's expansion projects.
- After collecting the additional surface water, the detention basin concentrated it to and through a 36-inch pipe, and the water intruding upon the landowner's property increased in terms of total volume and duration of discharge.
- A channel on the landowner's property eroded after the District installed a detention basin, 36-inch pipe, and berm.

Accepting the trial court's findings as supported by the evidence, the Commonwealth Court concluded that the trial court erred in applying the "common enemy rule" to the facts of this case.

As the Commonwealth Court has interpreted the law concerning the need for off-site stormwater easements, I cannot recall a project where an applicant did not construct a stormwater basin to collect the stormwater to reduce the rate of flow onto the adjacent property; however, in such case, the total volume of stormwater discharge was increased. How can it not? If additional improvements are being constructed, there will be more stormwater, there will be a need to contain that stormwater in a basin and then that stormwater must be released. Last this author checked, stormwater continues to flow, like it or not, to the downstream properties. An upstream property owner should not be prevented from discharging an increased volume of stormwater onto a downstream property if they have reduced the rate of runoff required by the municipality and DEP. That is exactly what the Pennsylvania Supreme Court held in 1906 in the *Strauss* case in allowing a property owner to make a "proper and profitable" use of their land even though such use may result in a change in the quality or *quantity* of water flowing to the lower land. The Commonwealth Court completely ignored the law established by the Supreme Court in *Strauss*; not to mention the Pennsylvania Stormwater Management Act and other DEP regulations/design guidelines on the subject. This issue may need further clarification by the Supreme Court, the State Legislature, the Governor or DEP.

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Update on the New Jersey Economic Opportunity Legislation

By Jeffrey M. Hall

April is typically a quiet period for the New Jersey Legislature, which is in recess, but there was some activity on the pending economic legislation introduced at the end of March. This activity and the anticipated introduction of the Economic Opportunity Act of 2014, Part II merits a brief update. As reported in the March issue of *In the Zone*, bills introduced by Senator Raymond Lesniak as the Economic Opportunity Act of 2014, Part I, and the Economic Opportunity Act of 2014, Part III, were intended to correct errors in the New Jersey Economic Opportunity Act of 2013

but also supplement the existing law. See the March issue of *In the Zone* for a brief overview of these bills.

Part I (S928) received legislative committee consideration last month. It had been introduced in January and referred to the Senate Economic Growth Committee, which reported favorably on the bill engrafting some amendments in late January. It was next referred to the Senate Budget and Appropriations Committee which, on March 24th, reported favorably on the bill and sent it to the entire Senate for consideration despite a tepid fiscal impact analysis by the Office of Legislative Services (OLS). In that analysis, OLS warned that the bill may have a negative fiscal net impact of unknown magnitude in concluding that any indirect revenue gain from the residential redevelopment projects benefitting from the legislation would probably be less than the State's direct cost of providing additional ERGG tax credits. Notwithstanding that analysis, S928 was referred out, put to a vote and passed the Senate by a 34 to 2 margin on March 27th. The companion legislation, A2716, is presently before the Assembly Commerce and Economic Development Committee for consideration.

The Economic Opportunity Act of 2014, Part II, has been withheld from introduction by the Senator to date. An informed source believes it could be dropped in early May and will include a significant increase in tax credits for residential projects. While this remains to be seen, the granddaddy of them all, the New Jersey Economic Opportunity Act of 2013, has been widely embraced with many developers and municipalities seeking to take advantage of its provisions. Thus, there now appears to be a significant backlog of applications awaiting agency action. We will continue to follow this progressive legislation as it wends its way through the Legislature.

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What Happens When an Owner Wants To Obtain a Modification to a Zoning Condition?

By William F. Martin

On March 21, 2014 the Commonwealth Court of Pennsylvania delivered an unreported panel decision in the matter of *Emery v. City of Philadelphia Zoning Board of Adjustment* (2014 WL 1168813). In its decision, the court reiterated and applied the law which governs when an owner may obtain a modification of conditions which have been imposed upon a grant of zoning relief.

In 2006, Mr. Emery received a variance to expand his Philadelphia restaurant into an additional portion of the building in which it was located. The variance was granted with a proviso requiring "all venting above the roof; commercial trash pick-up seven days a week. All trash stored inside the building." In 2011, the City of Philadelphia's Department of Licenses and Inspection issued a violation notice for the property, highlighting a failure to comply with the proviso regarding trash storage/ removal. The owner appealed the violation to the Zoning Board of Adjustment (ZBA) and requested that the proviso be removed. "…on grounds of undue hardship."

At the hearing before the ZBA, the owner's attorney argued that the indoor storage of trash created a fire hazard and the daily commercial trash pick-up was an excessive requirement given the amount of trash generated by the small restaurant. However, a neighboring property owner argued to the ZBA that trash was being placed in an outdoor dumpster, and blocking a shared driveway. The ZBA unanimously denied the appeal.

The owner appealed to Philadelphia Common Pleas Court, which confirmed the ZBA decision, reasoning that there had been no error of law and that the ZBA decision was supported by substantial evidence. On appeal to Commonwealth Court, the owner argued that the proviso should have been modified because of a demonstrated change in circumstance since the application of the 2006 proviso.

The Commonwealth Court based its analysis on the cornerstone that an owner that wishes to obtain a modification of a zoning condition must establish 1) grounds for a traditional variance, or a change in circumstance, which render the prior condition inappropriate, and 2) no injury to the public interest. In the *Emery* decision the Commonwealth Court stated that "…Owner was required to demonstrate some factual basis with regard to changes in circumstances to justify a conclusion that the original conditions were no longer appropriate." In determining whether this test had been met, the Commonwealth Court noted that there was no demonstration that the owner had ever retained the commercial trash hauler required by the original proviso, and that he had failed to demonstrate that modifying the proviso would *not* cause harm to the public. As such, the Common Pleas Court order was affirmed.

The lesson for property owners is that any attempt to alter a condition placed upon zoning relief needs to focus on the requirement of demonstrating a change in circumstances, along with a demonstration that the condition is not required to promote the public interest. While not necessarily a high hurdle to achieve, it is a fact-intensive one, and the initial determinations of local zoning boards are likely to be granted significant deference.

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Legislative Update in Pennsylvania

By David H. Comer

House Bill No. 2045 proposes to create an act known as the "Tax Exemption and Mixed-Use Incentive Program," which, in part, could provide tax abatement for refurbished properties.

In short, the act would authorize local taxing authorities – a "local taxing authority" is defined as a "county, city, borough, incorporated town, township, institution district or school district having authority to levy real property taxes" – (i) to provide for tax exemption incentives for certain deteriorated industrial, commercial, business and residential property and for new construction in deteriorated areas of economically depressed communities, (ii) to provide for an exemption schedule, and (iii) to establish standards and qualifications

One of the members of the House who introduced House Bill No. 2045 was Representative Jerry Stern, who represents a portion of Blair County, PA and has been a member of the House since 1993. In a memorandum summarizing the proposed legislation, Stern provides that the "legislation allows developers and property owners to receive a tax abatement incentive once they apply and are approved to rebuild upon an abandoned or blighted property or in a deteriorated area."

This proposed legislation would allow developers and property owners to receive a tax abatement incentive if certain requirements are met. As Stern points out, pursuant to his proposed legislation, "properties must fulfill specific requirements, such as being a 'deteriorated property,' correct all code violations, conform to zoning requirements and increase the property value by at least 25 percent."

House Bill No. 2045 provides that for the first, second and third years for which new construction or improvements would otherwise be taxable, 100 percent of the eligible assessment would be exempted.

A breakdown of exemptions per year, for which new construction or improvements would otherwise be taxable, follows:

- For the fourth year- 90 percent of the eligible assessment would be exempted
- For the fifth year - 75 percent of the eligible assessment would be exempted
- For the sixth year - 60 percent of the eligible assessment would be exempted
- For the seventh year - 45 percent of the eligible assessment would be exempted
- For the eighth year - 30 percent of the eligible assessment would be exempted
- For the ninth year - 15 percent of the eligible assessment would be exempted
- For the tenth year - 10 percent of the eligible assessment would be exempted
- After the tenth year the exemption would terminate

As for the status of House Bill No. 2045, it has not yet been passed. After House Bill No. 2045 was introduced, it was referred on February 26, 2014 to the House Committee on Urban Affairs, where it remains.

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Transactions

Trenton, NJ Zoning Board of Adjustment Approves Food Preparation and Distribution Hub

In this matter, Fox's client (Applicant), represented by Jeffrey M. Hall, applied for a use variance to repurpose a vacant commercial building to create a food preparation and distribution business in Trenton, New Jersey. Two commercial kitchens were proposed to operate at the facility and the remaining space would be used to manufacture, store and distribute food-related products for off-site sales and distribution. The property is located in the Residential B Zone District requiring the use variance. The ZBA approved the use variance and a parking variance, and also granted waiver of site plan review, noting the proposed use was less intense than previous non-residential uses. Minor conditions were imposed by the Board.