In the Zone

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The Problem with Particular Sustainability

By Henry L. Kent-Smith

Since the Great Recession of 2008, New Jersey's economy has seen the collapse of commercial financing and a substantial slowdown of retail and commercial land use development. The recession has caused substantial losses to municipal tax revenues as a result of the diminution of property values. New Jersey has suffered the "double whammy" of high unemployment and decreasing municipal tax revenues.

In the teeth of the Great Recession, New Jersey has further tightened the reins on job-producing commercial development opportunities. Recent cases interpreting the "particular suitability" standard for commercial use variances reaffirm and increase the stringent proof requirements necessary to secure a commercial use variance. Therefore, non "inherently beneficial" use variances have become extraordinarily difficult to secure, and if challenged, difficult to successfully defend on appeal.

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The use variance is a power delegated exclusively to the Zoning Board of Adjustment pursuant to N.J.S.A. 40:55d-70(d). A use variance provides a site-specific zoning option for property owners and developers. New Jersey courts have constrained the ability of a private applicant to secure a use variance, through recent tightening of the standards first annunciated in *Medici v. BPR*, 107 N.J. 1 (1987). In *Medici*, the New Jersey Supreme Court held that showing of the positive criteria is site specific — the applicant must show that the proposed use is "peculiarly fitted to the particular location for which the variance is sought" (*Medici, citing Kohl v. Mayor of Fair Lawn*, 50 N.J. 268, 279 (1967)). Proof of the "positive" criteria requires a showing of "special reasons," which are defined by the purposes of zoning listed in the Municipal Land Use Law N.J.S.A. 40:55D-2. Since 1987, the Supreme Court has held that special reasons also required the applicant prove that the property "is particularly suitable for the proposed use" (*Medici v. BPR Co.*, 107 N.J. 1, 17-18 (1987); *Saddle Brook Realty v. Saddle Brook*, 388 N.J. Super., 67, 76 (App. Div. 2006)).

Case law does not provide a precise definition of the meaning of "particular suitability." In *Medici*, *supra*, 107 N.J. at 24, the court concluded that the property for which a motel and restaurant were proposed was not "particular suitability" for such development. The only reason given to support particular suitability was because the site was near an interstate highway interchange. Other properties in the municipality were also near the interchange. In determining this fact was insufficient to show "particular suitability," the court stated that "particular suitability" contemplated "the development of a site in the community that is particularly appropriate for that very enterprise" (Id. at 18).

In cases following *Medici*, courts have expanded on the concept of particular suitable location. *In Funeral Home Management v. Basralian*, 319 N.J. Super. 200, 208 (App. Div. 1999), the Appellate Division held that the subject property was not particularly suitable for a funeral home because "the board made no finding that a funeral home use was not available in other locations in the area, or indeed, that there was a community need for such use" (Id. at 211). The court found particular suitability exists where, generally, the use is one that would fill a need in the general community, where there is no other viable location, and where the property itself is particularly well fitted for the use, either in terms of its location, topography or shape (Id. at 210). In *Saddle Brook Realty*, supra, 388 N.J. Super. at 81, the Appellate Division reversed the board's grant of a use variance to build a fast food restaurant in a shopping center. The court found the property was not "particularly suitability" for that use because the applicant did not establish the location "is a more suitable location ... than any other location in the ... commercial district, which is a prerequisite for finding that there are special reasons justifying a use variance" (Id. at 77).

These cases have understandably led trial courts to conclude that the

applicant for a use variance must show that other properties could not be used for the particular use, and the applicant's property **must** be the site for the proposed use in order to promote the general welfare. This proof standard presents an evidence quandary that is problematic: to prove the negative that there exists no other appropriate location in the municipality for the proposed use, as well as to prove the positive that the particular property is uniquely and well-suited for the proposed use. The result is numerous decisions in which trial courts have reversed the grant of use variances (*Kinderkamack Associates v. Mayor of Oradell*, 421 N.J. Super. 8, 21 (App. Div. 2011) and unpublished decisions in *Wawa v. Old Bridge; Bowie-McCready v. Morristown; Krousos v. Zoning Board Adjustment Paramus*; and *Iron Mountain Properties v. Twp. of Freehold*). In each of these cases, the court relies upon the "particular suitability" standard to find that the zoning board's action in granting a use variance was not legally sufficient, insofar as the applicant failed to demonstrate that the proposed property was uniquely suitable, and that the proposed use could not have been located elsewhere in the municipality.

This evolution of use variance proof standards is exacerbated relative to property specific zoning issues because of the Supreme Court's recent reaffirmation that spot zoning is not permitted. Unlike many other states, New Jersey law has tended to view property specific rezoning as impermissible "spot zoning." See *Riya Finnigans v. South Brunswick*, 197 N.J. 207 (2008). In *Riya Finnegans*, the Supreme Court reaffirmed that zone changes affecting particular properties made outside of recommendations of the Master Plan, which either inure to the direct benefit of the property owner (spot zoning) or impose a increased burden on a single property owner not shared by adjoining properties (inverse spot zoning), are legally suspect. In short, property specific rezoning in New Jersey is legally suspect. The *Riya* case makes planning for particular uses that have unique site characteristics, or which are viewed by the municipality as nuisances, extraordinarily problematic Therefore, property specific zoning relief can only be brought about through the use variance process. Otherwise, a site specific rezoning has a high likelihood of being found to be impermissible "spot zoning."

With the screws tightening on the ability to legally secure use variance relief, the evolution of the use variance particular suitability standard has had the perverse and unwanted loss of economic and commercial ratables and the jobs associated therewith in the face of the greatest economic recession of our generation.

The time has come for New Jersey to seriously re-evaluate the Municipal Land Use Law, and in particular, the legal standards associated with site-specific relief for commercial uses. To rely on general zoning ordinance changes, particularly in the face of the recent amendment to the Municipal Land Use Law that only requires Master Plan re-examination once a decade. See N.J.S.A. 40:55d-89, as amended by P.L. 2011 C.65. In light of now the 10-year presumptive validity of the Master Plan as it relates to local zoning, it is likely that New Jersey will continue to lag behind the rest of the nation because of its arcane zoning ordinances that are no longer reflective of modern market services and the transformative aspects of retail and commercial development that are at the core of a healthy and functional capitalist system.

Author

Henry L. Kent-Smith
609.896.4584
hkent-smith@foxrothschild.com

Case Study: *Commerce Bank/Harrisburg, N.A. v. Kessler*

By Robert W. Gundlach, Jr. and Clair E. Wischusen

In May 2012, the Superior Court of Pennsylvania filed its decision in *Commerce Bank/Harrisburg, N.A. v. Kessler*. Its decision turned a commonly held belief among title companies — that the Mechanics' Lien Law provides a lien priority "safe harbor" for all open-end construction mortgages — upside-down. As a result, property owners are likely to have a more difficult time removing exceptions for mechanics' liens from title policies, especially for recently constructed or improved properties. Lenders should update their best practices to reflect a more complex lending landscape.

In *Kessler*, purchasers contracted with a builder to construct a luxury home, and soon thereafter the builder commenced excavation. Subsequently, the purchasers borrowed a construction loan of up to $435,000 with an open-ended mortgage. The purchasers used the loan for construction and other debts. Eventually, the purchasers failed to make their payments to the builder and defaulted on their mortgage. The bank, and later the builder, both obtained default judgments against the purchasers who filed for bankruptcy soon after.

The home was destined for a sheriff's sale, but both the bank and builder filed a "Joint Emergency Motion to Stay Sheriff's Sale and Adjudicate Lien Priority Dispute." The trial court continued the sheriff's sale and later entered an order holding that the builder's judgment enjoyed priority over the bank's. On appeal, the Superior Court affirmed the trial court's judgment in favor of the builder, but on different grounds.

Section 1508 of the Mechanics' Lien Law determines the priority of contractor's mechanics' liens and liens for construction financing. Prior to January 1, 2007, mechanics' liens enjoyed priority over competing liens if the competing lien was filed after the date of visible commencement upon the ground of erecting or constructing improvements. Amendments to the Mechanics' Lien Law took effect on January 1, 2007 and Section 1508(c)(2) created an exception to mechanics' lien priority for "[a]n open-end mortgage ... the proceeds of which are used to pay all or part of the cost of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage." Until *Kessler*, title companies treated this exception as a "safe harbor" for all open-end construction mortgages.

The trial court found that the exception did not apply because the construction commenced prior to January 1, 2007. The appeals court rejected this analysis, finding that Section 1508's clause, "[a]ny lien obtained under this act," unequivocally applied to *all* liens obtained after January 1, 2007, regardless of when work had commenced.

The appeals court found in favor of the builder on other grounds. The court interpreted the use of the terms "the proceeds" in Section 1508(c)(2) to mean *all* of the proceeds of an open-end construction mortgage. Therefore, where work has already commenced, open-end construction mortgages only have priority over mechanics' liens when *all* of the open-end construction mortgage's proceeds are used for costs associated with erection, construction, alteration or repair of the mortgaged property. Because the purchaser's open-end mortgage was used for other purposes, the exception did not apply, and the mechanics' lien retained priority over the mortgage.

Title companies, stripped of their safe harbor, now determine on a case-by-case basis whether a mechanics' lien exception can be removed from a loan policy when construction is involved. Some underwriters in states known to favor construction parties are moving toward providing no mechanics' lien coverage at all.

However, since *Kessler*, there have not been significant changes in an owner's ability to remove the mechanics' lien exception from title insurance. The best position for an owner is still where no work has been performed on an existing property within the last six months and no mechanics' liens have been filed. If work has commenced within the past six months, owners face an uphill, case-by-case battle. Some underwriters, however, may be willing to remove the mechanics' lien exception for newly completed construction such as homes located in developments.

The bottom line for lenders is clear: open-end mortgages will not have priority over mechanics' liens where work commences prior to recording the mortgage and any amount of the mortgage is used for costs other than erection, construction, alteration or repair of the mortgaged property. For these reasons, it is more important than ever that lenders implement or continue best practices, such as requiring an owner to disclose prior to closing whether work has been done and when it commenced. Lenders should review financial documents and construction contracts and monitor whether payments are current.

Lenders may mitigate risk by paying contractors directly or requiring mechanics' lien waivers. Lenders should also consider whether to bifurcate loans and structure one portion to only be used for erection, construction, alteration or repair of the mortgaged property. In the event of default, under *Kessler*, this portion of the loan will enjoy priority.

Fox Rothschild will continue to monitor the *Kessler* decision to keep clients apprised of any subsequent appeals or legislative action.

Author

Robert W. Gundlach, Jr.
at 215.918.3636
rgundlach@foxrothschild.com

Author

Clair E. Wischusen
215.918.3559
cwischusen@foxrothschild.com

When a Security Deposit is Not Enough: Perfecting a Security Interest in Your Tenant's Assets

By Andrew D. Santana

When negotiating a commercial lease, landlords must often determine the credibility of the proposed tenant and determine what security can be given for the tenant's performance under the lease. The most often used methods of security in the case of commercial leases are security deposits and prepaid rent. However, the Pennsylvania Landlord and Tenant Act restricts the amount of security deposit and transactions that require tenants to expend large amount of cash and are often refused or rejected. Therefore, the landlord should use other means to secure the tenant's obligations.

The most common alternative form of security is to obtain and perfect a security interest in the tenant's personal property (i.e. assets other than real estate), which may include furniture, fixtures, equipment, inventory, securities and accounts receivable. This article provides an overview of the process of perfecting a security interest in a tenant's assets and addresses related issues that are often overlooked in the lease negotiation process.

Generally, perfecting a security interest in a tenant's personal property provides the landlord with a right to take that personal property, subject to prior liens, in order to satisfy the tenant's obligations under the lease. However, before entering into this type of transaction, it is important to address two significant issues. First, the landlord should determine whether the personal property is valuable. This can be done informally or formally. A landlord can determine the value of the tenant's personal property by reviewing a list of such personal property provided by the tenant and making a determination based on the landlord's knowledge of the personal property to be collateralized. On the other hand, a more formal appraisal may be conducted. Assuming that the personal property is valuable, the landlord must next determine whether the personal property subject to prior liens. If the personal property is subject to prior perfected liens, those prior liens will take priority over the landlord's lien, and therefore, a landlord must determine whether the junior lienholder position is sufficient to secure the landlord's interest. Assuming that the assets are valuable and are not subject to prior liens or there is sufficient equity in the assets that the landlord is comfortable with a junior lienholder position, several steps must be undertaken to perfect a security interest.

First, the landlord must include, in the lease, provisions akin to a security agreement that grant the landlord a security interest in the tenant's personal property. To be enforceable against the tenant, the tenant must receive something of value, the tenant must have the right to grant the interest in the collateral, and the personal property must be described in detail. The description of the collateral must be very specific, enumerating all items of collateral to be subject to the security interest. It is important to note here that a general description, such as "all assets," is insufficient for purposes of creating a security interest in the tenant's personal property. The tenant must sign the security agreement or a lease that includes language akin to a security agreement. Automatically upon the satisfaction of the conditions listed above, a security interest in favor of a landlord will attach to the personal property.

Assuming that the security agreement is properly attached to the collateral, the landlord then must "perfect" its security interest. A security interest that is not perfected will be junior to all perfected interests and all prior recorded unperfected interests. A security interest that is perfected has priority over all unperfected creditors, all unsecured creditors and all later-filed, perfected security interests.

There are several ways in which a landlord can perfect a security interest in a tenant's personal property. For example, the landlord may file a financing statement, commonly known as a UCC-1, with the Pennsylvania Department of State, or take possession or control of certain personal property. The manner of perfection will depend on the type of collateral in which the security interest has been granted. Upon perfection, the landlord's order of priority will be held for a period of five years. Perfection will lapse after five years unless the landlord takes certain acts to continue its perfection. In order to continue its perfection, the landlord must file an amendment to its financing statement, commonly known as a UCC-3, with the Pennsylvania Department of State. If perfection lapses, the landlord's security interest is deemed to have never been perfected. Therefore, even a creditor who has obtained a security interest after the landlord perfected its security interest will have priority over the landlord if the landlord's perfection lapses.

In an event the landlord takes possession of the collateral in order to perfect its security interest, the landlord has certain duties that must be undertaken for the benefit of the tenant. First, the landlord has a duty to exercise reasonable care in the custody and preservation of the collateral in the landlord's possession. Second, in

certain circumstances, a landlord may be required to provide an accounting of all of tenant's personal property held in the landlord's possession.

Upon satisfaction of the underlying indebtedness or obligation, the landlord has a duty to file an amendment to its financing statement terminating its perfected interest. Assuming the landlord has properly perfected its security interest and maintained that perfection in the tenant's collateral, then the landlord has certain remedies that would otherwise not be available in the case of a tenant's default under the lease. In the event the tenant commits a monetary default under the lease or any other default that requires the payment of money to the landlord or any third party, the landlord may take possession of the collateral in which the security interest was granted and perfected, provided the landlord does not breach the peace in doing so. The landlord may sell and dispose of the collateral and use the proceeds of that sale or disposition to satisfy any indebtedness to the landlord. In the event the collateral is cash or cash equivalents (for example, accounts receivable), the landlord has a right to collect such cash or cash equivalents and apply those amounts to any indebtedness of the tenant.

The foregoing is a summary of the process through which a landlord may perfect a security interest in a tenant's personal property as security for a tenant's performance under a lease. Although the process seems simple as described below, it is actually quite nuanced. More importantly, a landlord who wishes to perfect a security interest in its tenant's personal property must strictly comply with all provisions of the applicable Commercial Code to acquire the rights and remedies described above.

For example, the following issues should be addressed in the lease agreement and the financing statements, if any, in order to ensure that the landlord's security interest is properly perfected and remains perfected:

1. Confirm title to the tenant's personal property is free and clear of any liens or encumbrances.
2. Confirm the tenant's legal name and require that the tenant provide notice of any name change.
3. If the tenant is a business entity, confirm the tenant's state of formation.
4. Require that the tenant maintain an accurate accounting of the collateral and provide a copy of the accounting to the landlord upon written landlord's request.
5. Require that the tenant disclose the location of the collateral and prohibit the tenant from changing that location at any time.
6. Require that the tenant provide notice to the landlord of any casualty affecting the collateral.
7. Restrict or prohibit the disposition of the collateral by the tenant.
8. Require that the tenant maintain the collateral in good condition and working order and preserve the value of the collateral.
9. Prohibit the tenant from granting any other security interest in the collateral to any other parties.
10. Require that the tenant insure the collateral.
11. Require that the tenant pay taxes that may affect the collateral as and when due.
12. Grant the landlord the authority to file financing statements as and when appropriate in order to perfect and maintain its security interest.
13. Grant the landlord the right to audit and inspect tenant's books and collateral to confirm the value and amount of the collateral.

While security deposits and prepaid rents are often sufficient security for a landlord, those landlords who enter into leases with significant monetary values or tenants with less than excellent credit should acquire and perfect a security interest in its tenant's collateral to secure the tenant's obligations to the landlord. In the event the security deposit and the prepaid rent are not sufficient to recoup a landlord's costs over the terms of a lease, the right to the collateral may do so. In addition to the cash that may be derived from the collateral, the threat of taking such collateral provides a significant bargaining tool for a landlord that wishes to maintain compliant and cooperative tenants.

Author

Andrew D. Santana
610.397.7965
asantana@foxrothschild.com

Selected Issues Under Participation Agreements

By Melvyn J. Tarnopol

Sometimes, lenders like to offer to sell interests in their loans to various participants. The agreement that governs such sale, and the rights and obligations of the seller and buyer of an interest in the loan, is called a Participation Agreement.

A Lender and a Participant have similar interests in that each wants the borrower to repay the loan and comply with its obligations under the loan. However, there are sometimes points of contention between the Lender and the Participant. The article will touch on a few of those points.

By way of background, a Participation Agreement provides for the Lender to sell to the Participant a portion of an existing loan. For example, if a loan were in the amount of $50 million and a Participant wanted to buy a $20 million participation, then the Participant would be buying a 40 percent participation in the loan. Such a participation is ordinarily evidenced by a Participation Certificate, which lists the loan, the amount of the loan being purchased by the Participant, the date of the participation and similar information. In addition to making the participation payment, the Participant also pays to the Lender a one-time participation fee; a monthly servicing fee based on the outstanding principal balance of the loan; and the Participant's percentage share of any expenses incurred by the Lender in connection with the enforcement of the loan.

The Participation Agreement also provides representations from the Lender to the Participant as to such things as the accuracy of the documentation comprising the loan; that all payments under the loan have been paid to date; and that there is presently no notice of default sent by the Lender. Other than that, a lender will resist making any additional representations to the Participant. In particular, the Lender will make clear that the Participant has made its own credit analysis regarding the borrower; and as to the legality and effectiveness of the loan documents, the accuracy of any representations made by the borrower, the adequacy of the collateral, and the existence and priority of security interests.

Additionally, the Participation Agreement covers how the Lender is to deal with the Borrower, including prohibitions on the Lender changing the interest rate; increasing the principal balance of the loan; extending the maturity of the loan; forgiving principal or interest; releasing collateral; releasing obligors; postponing payment dates; permitting encumbering the property; changing definitions relating to default; permitting transfers of the mortgaged property; and making other material modifications. If there is default, the Lender is obligated to exercise the same standard of care that it does in its other loan transactions, which would include pursuing remedies as it ordinarily would do. In that regard, the Lender is required to give the Participant notices as to the status of the loan and, if applicable, the Lender's exercise of its remedies.

Finally, the Lender will require that the Participant not further grant participation interests in the loan.

While there are numerous issues that can arise in the context of Participation Agreements, below are a few issues that I came across during recent transactions.

The first issue that arose was: what happens if the maturity date of the loan arrives and the Lender wants to extend the maturity date, but the Participant does not? Since a Participation Agreement ordinarily requires the Participant's consent to an extension of the term of the loan, the Lender would not have the right to extend unless the Participant consented. We resolved the situation by allowing the Lender to elect, at the Lender's option, to either buy out the Participant at par or to proceed with the foreclosure. Thus, the Lender would have the flexibility to either extend the loan or pursue its remedies.

A second issue that arose involved a restriction to which the Lender was subject under the Participation Agreement. A Participation Agreement would typically provide that the Lender is not allowed to postpone any payment date. This could present problems for a Lender if the Borrower is seeking a short-term postponement and the Lender does not want to have to go back to the Participant for consent in this situation. We resolved this issue by providing that the Lender could not agree to an extension beyond 30 days, which gave the Lender the flexibility it sought while protecting the Participant from long payment delays.

A third issue that arose was the Participant's demand that the Lender retain a certain percentage ownership in the loan and also that the Lender continue to service the loan. Basically, the Participant wanted to know that it could rely on the Lender's self-interest in treating the loan as it would have had it not sold participations.

As far as servicing the loan, a Lender will hesitate to agree to continue to service the loan itself unless it has no potential plans for out-sourcing the servicing. If a Lender were pressed on this issue, it could agree to service the loan itself unless the Lender was to farm out a certain percentage of its loan portfolio. In a negotiation in

which I was involved, the Lender refused to agree to any restriction as to how the loan was serviced.

As far as a Lender keeping a certain percentage of the loan, and thus limiting the percentage of the loan that it could sell to participants, one lender agreed that it would keep at least 51 percent of the loan, unless that Lender decided to sell more than 51 percent of the loan because of regulatory issues, requirements or concerns. Thus, the Lender, while giving the Participant the assurance that the Lender remained as a majority holder of the loan, protected itself if any regulatory agency pressured the Lender to sell the loan.

Author

Melvyn J. Tarnopol
609.572.2212
mtarnopol@foxrothschild.com

Legislative Update in Pennsylvania

By David Comer

House Bill No. 1718 proposes to amend the Pennsylvania Municipalities Planning Code (MPC) by, among other things, increasing the number of days that an applicant can dispute the amount of review fees from 45 to 100 days, clarifying the amount of the posted financial security that a municipality can retain and adding language that a municipality can only require financial security for a term not to exceed 18 months from the date of acceptance of dedication for **dedicated** improvements. The proposed amendment also revises the provisions regarding a potential arbitration involving a disputed fee.

Meanwhile, House Bill No. 1719 proposes to amend the Municipal Authorities Act by making similar revisions regarding review fees as in the MPC. For example, a property owner will have 60 days from the date of billing to dispute a bill instead of the previous 20 working days under the Municipal Authorities Act.

Author

David H. Comer
610.397.7963
dcomer@foxrothschild.com

Where is LEED Going?

By Philip Hinerman

Recently, the United States Green Building Council (USGBC) announced that it is delaying the balloting on a new and improved LEED standard for businesses and homes. The LEED standard has become the "gold" standard for sustainability. After revisions in 2009, a number of commenters had called for a major rewrite. This was to be called LEED 2012. Due to the delay, USGBC announced that the new standard will be renamed as LEED V.4, as it is unlikely that any changes will be made until June 2013 at the earliest.

Why did USGBC delay its revisions after it had three rounds of public comment? It is first important to understand what the proposed LEED 2012 standards would have modified. As with prior LEED standards, the intent was to help developing technologies become more "mainstream." LEED changes would have incorporated a number of Energy Star guidance revisions, made integrated process points important (these points are a way of training trades, businesses and homeowners) and would have modified points for new approaches to material selection.

The delay was a surprise since a number of revisions were made through four rounds of public comment. The delay has also been quite controversial. A number of building industry professionals took the position that the proposed changes were too much in a weak real estate market. However, most of the commenters had concerns about an increase in the LEED standards focus on "chemicals of concern" — materials incorporating chemical components. The standards were drafted to encourage use of non-chemical alternatives, such as limited use of vinyl siding.

The American Chemistry Council (ACC) had taken a strong position that the LEED proposals do not have a sufficient "science-based" approach. The ACC has lobbied the Federal Government to consider other building standards — after the government had committed to the use of LEED systems for many of its

buildings. The federal government is the single largest user of LEED ratings systems.

These delays have prompted many to argue that the explosive growth of USGBC and its membership has reduced the organization's ability to adapt to market changes and to promote aggressive innovation in the building industry.

This is the most significant challenge to the LEED system in the short life of the USGBC. The old rating system will remain in place for the time being, and the organization will have its 5th public comment period beginning in October and concluding in December.

Author

Philip L. Hinerman
215.299.2066
phinerman@foxrothschild.com