Directory

Ohio, Kentucky, Indiana, Michigan & Pennsylvania Retail Development & Law Symposium

For Lawyers and Real Estate Professionals

Retooling Retail Arenas: Version 20.19

Hilton Columbus/Polaris | Columbus, OH | February 28 – March 1, 2019 | #ICSC

Ohio, Kentucky, Indiana, Michigan & Pennsylvania Retail Development & Law Symposium

For Lawyers and Real Estate Professionals

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Section I

Program

THURSDAY, FEBRUARY 28

Registration
5:30 – 7:30 pm | Hilton Columbus/Polaris

Member-Hosted Reception
6:30 – 7:30 pm | Hilton Columbus/Polaris

Join your colleagues for refreshments and networking.

FRIDAY, MARCH 1

Registration
6:45 am – 4:45 pm | Polaris Foyer

Breakfast Served
7:15 – 8:00 am | Polaris Ballroom A-B-D-E

Roundtable Discussions
8:00 – 9:00 am | Polaris Ballroom A-B-D-E

Various topics will be presented in roundtable format for small-group discussion. All roundtable topics will be held twice, so participants may rotate to a different roundtable following the first 30-minute session.

A. Flying Above the Law? Commercial Drone Regulation in the U.S.

Patrick Abell, Esq.
Associate
Thompson Hine
Cleveland, OH

B. Importance of Concise Legal Drafting in Exclusives and Restrictions

Holly Ahrendt, Esq.
Senior Legal Counsel
Washington Prime Group
Indianapolis, IN

C. Ready for Your Closeup? Movie Licensing for Shopping Centers

David V. Allen, Esq.
Assistant General Counsel
Brookfield Properties/Forest City Realty Trust, Inc.
Cleveland, OH

D. Rights of First Refusal in Shopping Centers – Risks of Drafting Ambiguities

Caitlin Carey, Esq.
Associate
Honigman LLP
Kalamazoo, MI

E. Trying to Find Comfort – Letters of Intent and Similar Comfort Instruments – Enforceability and Related Issues

Kiamesha-Sylvia G. Colom, Esq.
Partner
Taft Stettinius & Hollister
Indianapolis, IN

F. Parking and Site Plan Issues: The Competing Interests of the Landlord and the Tenant

Joseph B. Conn, Esq.
Counsel
Ulmer & Berne, LLP
Cincinnati, OH

G. Access Agreements

David N. DeRoberts, Esq.
Attorney
Gallagher Kavinksy & Burkhart LPA
Cleveland, OH

H. Project Delivery and Pricing Methods

James T. Dixon, Esq.
Partner
Brouse McDowell
Cleveland, OH

I. Rooftop Generated Energy (Solar, Wind) and Ancillary Income Related Thereto

Joanne Goldhand
Partner
Ice Miller
Columbus, OH

J. Building Blocks: How Blockchain and Smart Contract Technology Could Revolutionize Commercial Real Estate Transactions

Nicholas R. House, Esq.
Associate
Vorys, Sater, Seymour and Pease
Cleveland, OH

K. Consolidating Parcels for Project Development

Kendall Kadish, Esq.
Associate
Keating Muething & Klekamp, PLL
Cincinnati, OH

L. Flexibility Needed By Startups in Commercial Leases

Adam M. Law, Esq.
Associate
Taft Stettinius & Hollister
Indianapolis, IN

M. 199A Business Income Deduction

Kevin F. McKeegan, Esq.
Partner
Meyer, Unkovic & Scott, LLP
Pittsburgh, PA

N. Holdover Tenancy and Holdover Provisions

Raymond D. Seiler, Esq.
Associate
Ulmer & Berne, LLP
Cleveland, OH

O. **What Is (And Is Not) Retail? Negotiating Medical, Office, Educational and Other Uses in the Hunt for Tenants**

Eric E. Landen, Esq.
Member
Frost Brown Todd LLC
Cincinnati, OH

P. **Airport Retail Leasing**

Robert C. Ziegler, Esq.
Partner
Ziegler & Schneider, P.S.C.
Covington, KY

Welcome and Introduction to the Program

9:00 – 9:15 am | Polaris Ballroom A-B-D-E

Melissa A. Breeden, Esq.
ICSC 2019 Ohio, Kentucky, Indiana, Michigan and Pennsylvania Retail Development & Law Symposium Program Planning Committee Co-Chair
Of Counsel
Dickinson Wright PLLC
Phoenix, AZ

ICSC UPDATE

Betsy Laird
Senior Vice President, Global Public Policy
ICSC
Washington, DC

Harlan W. Robins, Esq.
ICSC 2019 Ohio, Kentucky, Indiana, Michigan and Pennsylvania Retail Development & Law Symposium Program Planning Committee Co-Chair
Member and Deputy CEO – Finance/Diversity
Dickinson Wright PLLC
Columbus, OH

Concurrent Sessions

9:15 – 10:15 am

A. **Ethics and Professionalism: You Make the Call**
Polaris Ballroom C-F

Vignettes of professional and unprofessional conduct using newly released videos produced by the Colorado and Denver Bar Associations will be shown. Topics will include: client and counsel communication differences, client focus failure, client control, and professionalism in transaction deals. Attendees will have voting devices. The voting results will be followed by discussions on the pros and cons of each point.

Joseph N. Gross, Esq.
Partner
Benesch, Friedlander, Coplan & Aronoff LLP
Cleveland, OH

B. **Current Issues in Complex Commercial Mortgage Finance Transactions: How to Get Everything You Ever Wanted Without Trying Too Hard**
Gemini Ballroom

This informative session will set forth all of the provisions that originating lenders for securitized and syndicated loans are more than willing to give if the attorney makes the correct requests. This session will also present applicable counter arguments to when lender's counsel says that such items are not "negotiable." We will provide all of those "have to have" provisions that any real estate borrower should be requesting!

MODERATOR

James H. Schwarz, Esq.
Partner
Taft Stettinius & Hollister
Indianapolis, IN

PANELISTS

Susan Cornett, Esq.
Partner
Thompson Hine
Dayton, OH

Geoff White, Esq.
Member
Frost Brown Todd LLC
Louisville, KY

Break

10:15 – 10:30 am | Polaris Foyer

Concurrent Sessions

10:30 – 11:30 am

A. **Cannabidiol (CBD): A New Opening for Landlords in the Cannabis Industry and Other Concerns for Landlords in the Cannabis Space**
Polaris Ballroom C-F

The Controlled Substances Act, which designates cannabis (and all its cannabinoids) a Schedule 1 drug (i.e. with no recognized medical benefits), has greatly hampered the ability of owners to lease property to tenants in the cannabis space. Even if a state allows recreational or medical cannabis use, the threat of federal liability often prevents landlords from profiting from this industry. In a double-blind, placebo-controlled trial conducted at 30 clinical centers, the results of which were published in the New England Journal of Medicine (May 2018), Epidiolex, a drug that contains CBD, was found to dramatically reduce the occurrence of drop seizures in epileptic patients. CBD is not a psychoactive element. Based on these findings, the FDA approved the drug, and subsequently, the DEA reclassified any FDA-approved substances containing CBD as a Schedule 5 drug. In addition to cannabis-based CBD, industrial hemp naturally contains a high concentration of CBD compounds.

This panel will explore the medicinal benefits of CBD, its impact on current legislation and decisions that have been passed by various agencies and what this means to landlords as they attempt to navigate through the Controlled Substances Act.

MODERATOR

Joshua S. Weinberg, Esq.
Founder
Chatsford Law PLLC
Southfield, MI

PANELISTS

Martin H. Bluth, MD, PhD
Laboratory Director
Accutox Medical Diagnostics
Syosset, NY

Benton B. Bodamer
Member
Dickinson Wright PLLC
Columbus, OH

PANELISTS (CONTINUED)

Scot C. Crow, Esq.
Member and General Corporate
Dickinson Wright PLLC
Columbus, OH

Rob Sims, Jr.
Founder
Locker Room Consulting
Former NFL Player
Detroit, MI

B. Opportunity Zones for Real Estate Investment: Miracle or Mirage?

Gemini Ballroom

The Tax Cuts and Jobs Act of 2017 brought us a new category of tax incentives for real estate investment, through investment in Opportunity Zones. There are 8,700 Opportunity Zones in the US, the Virgin Islands and Puerto Rico, many in what may be characterized as distressed areas, but also many in gentrifying and even "hot" development areas. The tax incentives include deferral, and (depending on the holding period) exclusion of part of the capital gain, plus tax relief as to appreciation in value. Not surprisingly, it's complicated, and while some regulations have been issued, more are to come. What are the requirements for accessing the tax benefits offered by the OZ program? What pitfalls do investors and developers need to avoid? How can developers also meld this program with other federal incentive programs and state incentives, like proposed Ohio House Bill 727?

MODERATOR

Linda A. Striefsky, Esq.
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Cleveland, OH

PANELISTS

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Kris Brandenburg, Esq.
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Scott J. Ziance, Esq.
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Vorys, Sater, Seymour and Pease LLP
Columbus, OH

Break

11:30 – 11:45 am | Polaris Foyer

Concurrent Sessions

11:45 am – 12:45 pm

A. Show Me the Retail Money: Multi-Channel Retail Solutions to the Retail Leasing Challenge

Polaris Ballroom C-F

Today's most successful retailers have figured out how to implement a seamless multi-channel sales program. Because this requires a physical presence, multi-channel retail provides new opportunities for retail landlords. This presentation will discuss opportunities like pop-up stores and problems presented like showrooming in implementing a multi-channel retail program.

Scott P. Kadish, Esq.
Partner
Ulmer & Berne, LLP
Cincinnati, OH

Brian McAllister, Esq.
Senior Director, Leasing Counsel
Washington Prime Group, Inc.
Columbus, OH

B. PACE Is the New Green: How PACE Provides a Green Financing Option for Building Transformation

Gemini Ballroom

Property Assessed Clean Energy (PACE) is an innovative mechanism for financing energy efficiency and renewable energy improvements on private and public property, and PACE programs now exist for both commercial and residential properties. In this session, you'll learn how the up-front costs of energy and other eligible improvements can be financed under PACE, how PACE affects property tax bills and how to work with state, county and local governments known as "land-secured financing districts" or "energy special improvement districts" to get a PACE project approved.

MODERATOR

Thomas P. Vergamini, Esq.
Of Counsel
Taft Stettinius & Hollister
Covington, KY

PANELISTS

John Caleb Bell, Esq.
Partner
Bricker & Eckler LLP
Columbus, OH

Jeremy Druhot
Manager
Columbus Franklin County Finance Authority
Columbus, OH

Chris Jones
Executive Director
PACE Financing
Greater Cincinnati Energy Alliance
Cincinnati, OH

Lunch Served

12:45 – 1:15 pm | Polaris Ballroom A-B-D-E

No lunch service after 1:15 pm.

Keynote Presentation

1:15 – 2:15 pm | Polaris Ballroom A-B-D-E

Cool or Die: The New Paradigm for Experiential Retail

In this informative and entertaining session, Cushman & Wakefield's head of retail research, Garrick Brown, will discuss the current retail landscape and how new commerce has changed the traditional retail paradigm of convenience, value and experience. Among the topics that Mr. Brown will cover are the rise of Amazon, the impact of e-commerce on different retail categories (past, present and future), the drive towards live/work/play and the increasing amenitization of retail. During this session, Mr. Brown will discuss clicks-to-bricks concepts, elevated food and beverage (from eatertainment to food halls) and both the macroeconomic and demographic economic shifts that are driving it. In the new retail paradigm—driven by the millennial consumers—cool is anything but a frivolous word. When it comes to experiential retail, it truly is Cool or Die.

Garrick Brown
Vice President, Retail Intelligence – The Americas
Head of Retail Research
Cushman & Wakefield
Buffalo, NY

Break

2:15 – 2:30 pm | Polaris Foyer

Concurrent Sessions

2:30 – 3:30 pm

A. The Doctor Is In: An Evolving Market for Medical Leasing

Polaris Ballroom C-F

It's a changing market for medical providers. No longer restricted to on-campus offices and nearby Professional Office Buildings (POBs), medical providers are ranging far afield, locating offices, clinics and micro-hospitals in locations driven by evolving market demographics and space opportunities.

Dudley Carpenter
Senior Vice President, Real Estate
Emerus
Houston, TX

Dusty Elias Kirk
Partner, Global Real Estate Practice Group
Reed Smith
Pittsburgh, PA

Christopher Reinard
Counsel
Highmark Health
Pittsburgh, PA

Jonathan Winer
Senior Managing Director
Seavest Healthcare
New York, NY

B. That Was Then, This is Now: Dealing with Existing REAs in Today's Evolving Retail Centers

Gemini Ballroom

This session will focus on the frequent need to amend an REA to accommodate a proposed redevelopment of an existing shopping center versus amending and restating the REA in its entirety. The discussion will address the competing desires and requirements between the developer entity and the other big box/anchor store parties to an REA for value enhancing changes such as additional permissible building areas, outparcels, hotels and residential components. Practical approaches, considerations and solutions will be explored.

Derek K. Koget, Esq.
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Pittsburgh, PA

Tandy C. Patrick, Esq.
Partner
Bingham Greenebaum Doll, LLP
Louisville, KY

Christina M. Sprecher, Esq.
Member
Frost Brown Todd, LLC
Cincinnati, OH

Break

3:30 – 3:45 pm | Polaris Foyer

Concurrent Sessions

3:45 – 4:45 pm

A. Assumption, Rejection or What's Behind Door No. 3: What's a Landlord to Do About Sales of Leases in a Retail Chapter 11 Bankruptcy?

Polaris Ballroom C-F

The recent surge in retail bankruptcy filings often leaves commercial landlords in the frustrating position of waiting until their debtor-tenant decides whether to assume or reject an unexpired lease. Assumption, with its attendant cure of past defaults, is often met with a sigh of relief. Rejection, on the other hand, may leave a landlord scrambling to find a tenant to fill suddenly vacated space. But some very recent chapter 11 debtors, including Toys "R" Us and The Bon Ton Stores, have even added some additional twists to this often frustrating scenario. First, they delay assumption-rejection decisions until after they know if the sale of their assets, including unexpired leases, will be to an operating or a liquidating buyer, often leaving previously negotiated lease modification agreements in limbo. Then, if the buyer is of the liquidating kind, this will mean that the debtors' rights under their leases are in the hands of such third parties, who will have their own agendas, motivations and strategies. This panel will (i) explore the various issues facing commercial landlords caused by these debtor strategies, (ii) discuss the options available when confronted with these strategies, and (iii) identify ways in which commercial landlords may use these strategies to their own advantage.

MODERATOR

Bruce J.L. Lowe, Esq.
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Taft Stettinius & Hollister
Cleveland, OH

David W. Ross, Esq.
Shareholder
Babst Calland
Pittsburgh, PA

B. Cybersecurity is the New Black: How Are You Securing Your Data?

Gemini Ballroom

More cybersecurity incidents occur every day. More data privacy legislation and court rulings emerge at both the state and federal levels. Now cybersecurity is critical at every stage of business operations and in every industry, including real estate. This session will survey the current U.S. cybersecurity landscape. We will look at the new or soon-to-be privacy laws and the data privacy and cybersecurity issues at the forefront in the real estate industry. You will learn the security-item checkpoints that should be on your radar as you start to go down the rabbit hole of just how secure your business is… or isn't.

MODERATOR

David A. Fantauzzi, Esq.
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The Cafaro Company
Niles, OH

PANELISTS

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Vice President of Operations
Donald P. Pipino Company, LTD
Boardman, OH

Frances Floriano Goins, Esq.
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Cleveland, OH

Sara H. Jodka, Esq.
Member
Dickinson Wright PLLC
Columbus, OH

Symposium Adjourns

4:45 pm | Polaris Foyer

Program information current as of February 25, 2019.

ICSC has been approved for Continuing Legal Education (CLE) credits for the states of Indiana, Kentucky, Ohio and Pennsylvania.

ICSC has been approved for the state of Ohio for Continuing Real Estate credits (Salespersons/Brokers/Agents).

PROGRAM PLANNING COMMITTEE

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Troy R. Brown, Esq., Singerman Mills Desberg & Kauntz Co., L.P.A.
Jerry M. Cyncynatus, Esq., The Irvine Company
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David L. Huprich, Esq. (dec.), Attorney at Law
Robert M. McAndrew, Esq., Ross Stores, Inc.
Kim A. Rieck, Esq., International Market Centers
Charles E. Schroer, Esq., Frost Brown Todd LLC
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Section II

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Section III

Session Outlines & Materials

Friday, March 1, 2019
9:15 – 10:15 pm

Concurrent Session A

Ethics and Professionalism: You Make the Call

SPEAKER

Joseph N. Gross, Esq.
Partner
Benesch, Friedlander, Coplan & Aronoff LLP
Cleveland, OH

I. Competence

   A. Know the parties
   B. Know the case/transaction
   C. Know the law
   D. Know the pitfalls

II. Unrepresented Parties

III. Communication with Opposing Counsel

IV. Obligations in Transactions with Opposing Counsel

V. Unequal Treatment and Bias

Competence
Rule 1.1 of the Model Rules of Professional Conduct

"A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for representation"

What is competence?

Know the parties
Know the case/transaction
Know the law
Know the pitfalls

Bailey's client, *XYZ*, is in some complex real estate trouble. Bailey, who does not practice real estate law, does not believe that he or anyone at his firm can properly advise *XYZ* as to its next step. But, after many painstaking conference calls and meetings with *XYZ*, Bailey, with the best intentions to take care of his client, agrees to represent *XYZ*.

Ultimately, *XYZ* spends thousands of dollars on this real estate matter and loses its rights to the property in issue. *XYZ* did not learn until after the loss that Bailey was inexperienced in real estate law. *XYZ* brings suit against Bailey.

Did Bailey act unethically by agreeing to take the matter when he knew that he did not have the requisite knowledge and experience?

> No, because when Bailey first took the representation he could have obtained the requisite knowledge to be competent on the matter.
>
> Yes, because Bailey knew that there was no way he could learn all the complexities of real estate law.

By representing *XYZ*, is Bailey susceptible to disciplinary action?

> No, as long as Bailey can prove that *XYZ* did not lose the property because of Bailey's lack of knowledge.
>
> Yes, because Bailey was not (and even with extensive research could not have been) competent to take the representation.

Unrepresented Parties

Rule 4.3 of the Model Rules of Professional Conduct

"In dealing on behalf of a client with a person who is not represented by counsel, the lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonably possibility of being in conflict with the interests of the client."

Unrepresented Party Transaction (Video 1(a))

How can a lawyer control a client in a circumstance like this?

Have another lawyer in the firm represent the buyer.

Tell the client that he needs a more complicated contract to protect his interests and avoid a lawsuit.

Force the client to deal with the buyer on each of the contract's terms.

Refuse to draft the agreement unless the buyer is represented.

What are some other options the lawyer could have proposed to satisfy the client? Choose the one you would recommend:

Consent to joint representation of both the buyer and the original client.

Organize a meeting between the original client and the buyer to explain the aspects of a transactional document.

Obtain a waiver from the buyer.

Explain the possible risks and implications of a simple agreement to the original client in detail.

What if the client had not agreed with the lawyer's advice? (Video 1(b))

The lawyer should try harder to convince the client to go along with her advice.

The lawyer should refuse to draft the documents until the client takes her advice.

The lawyer should call the buyer and determine whether the buyer is interested in moving forward with the sale even though he is not represented.

The lawyer should draft the documents in a way that protects the buyer.

What made this approach more successful than the approach taken in Video 1(a)? Choose the most appropriate:

The lawyer knew the client for many years and therefore had a personal relationship with him.

The lawyer refused to draft the documents in a simple, straightforward way.

The lawyer made sure the client understood the risks and implications of a simple and quick contract.

The lawyer made it seem like she had experience in these types of matters.

Unrepresented Party Transactions

Kathy primarily practices in the area of commercial real estate zoning and sales. Her client, Seth, is selling a parcel of land that Bill intends to use for one of his restaurants. In discussing the sale with Seth, Kathy discovers that Seth intentionally misled Bill to believe that the site is zoned for commercial use. Kathy also discovers that Bill is unrepresented. Kathy knows that it is zoned for residential use only. Seth wants Kathy to draft the purchase agreement for Bill, *only*. Kathy will have no other involvement with this transaction.

What should Kathy do in this situation?

Kathy should counsel her client to correct his mistake and if he does not, refuse to draft the agreement.

Kathy should inform Bill to obtain a lawyer.

Kathy should inform Bill that the land is only for residential use.

Kathy should say nothing and draft the purchase agreement.

Trouble with Technology

Communicating with Opposing Counsel (Video 1)

How did using technology to communicate with opposing counsel affect the communications as a whole? Choose the most accurate:

Persons communicating through email, text message, or instant message intend to informally resolve their disputes.

Persons reading email, text message, or instant message communications presume the worst.

Communications are shortchanged through email, text message, and instant message.

Persons communicating through email, text message, or instant message are more willing to make aggressive remarks because they do not have to look the person in the eye when saying them.

What could Lawyer 1 have done differently when communicating with Lawyer2 (opposing counsel)? Choose the most accurate:

Have the conversation over the phone rather than over email.

Have the conversation in person.

Send the email but communicate more respectfully.

Not discuss the issue at all but see if Lawyer 2 will act more professionally this time around.

What should Lawyer 2 (opposing counsel) have done differently when responding to the email sent by Lawyer 1? Choose the most accurate:

Send an even more scathing email in response.

Call Lawyer 1 and resolve the issue over the phone.

Set a meeting with Lawyer 1 to resolve the issue in person.

Not respond at all.

Communicating with Opposing Counsel (Video 2(a))

How did an email communication get <u>this</u> off track?

Persons communicating through email tend to rely on informal means to resolve their disputes.

Persons reading emails presume that the sender is using a rude or aggressive tone.

Persons communicating through email are more willing to make aggressive or rude remarks because it is easier to do so than when speaking directly to the individual.

How could Lawyer 1 (Barb) have communicated more effectivelywith Lawyer 2 (Charlotte)? Choose the most accurate.

Schedule a meeting to discuss the discovery discrepancies with Lawyer 2.

Call Lawyer 2 to discuss the discovery discrepancies.

Draft a more gently worded email to Lawyer

How should Lawyer 2 (Charlotte) have responded to Lawyer 1's (Barb's) email? Choose the most accurate:

Send an equally aggressive email in response to Lawyer 1.

Call Lawyer 1 to discuss the issues to ensure there are no miscommunications.

Ask Lawyer 1 if it would be possible to schedule a meeting to solve any issues that seem to have arisen.

Communicating with Opposing Counsel (Video 2(b))

Did Lawyer 2 (Charlotte) take the <u>best</u> approach? What other approaches may have worked here? Choose the most accurate:

If Lawyer 2 had sent an equally aggressive email to Lawyer 1, Lawyer 2 may have received a better result for her client.

Lawyer 2 could have immediately complied with Lawyer 1's request and not responded to the aggressive remarks at all.

No, Lawyer 2 chose the best course of action by picking up the phone and communicating thoughtfully and respectfully with Lawyer.

What if Lawyer 1 did not accept Lawyer 2's offer to communicate morepeacefully and respectfully? Choose the most accurate:

Lawyer 1's client may suffer as aresult of Lawyer 1's inability to work with opposing counsel.

Lawyer 2’s client may suffer as aresult of Lawyer 2’s inability to take an aggressive stance against Lawyer 1.

Lawyer 1 would have the upper hand in the case from that point forward. Lawyer 2

would have the upper hand in the case from that point forward.

Do you agree with *caveat emptor* in this situation? Will the

lawyers’ client *really* think they are geniuses?

Inequality and Bias New Attorneys

Rule 5.2 of the Model Rules of Professional Conduct

“(a) A lawyer is bound by the Rules of Professional Conduct notwithstanding that the lawyer acted at the discretion of another person.”

“(b)” A subordinate lawyer does not violate the Rules of Professional Conduct if that lawyer acts in accordance with a supervisory lawyer’s reasonable resolution of an arguable question of professional duty.”

Newly hired associate Alexandra has been working on a deal for the purchase of a chain of retail stores for nearly one year. The transaction should never have taken this long, however, sellers’ counsel, Donald, has been extremely lazy.

Finally, after months of stops and starts, Alexandra goes to Donald’s office to close the deal. Alexandra doubts that the closing will go smoothly. Nevertheless, the client, *XYZ,* is so eager to acquire the retail chain, its general counsel advised Joe, the partner in charge, to tell Alexandra to sign whatever they put in front of her.

After three days of working through a myriad of documents, Donald gives Alexandra a non- compete agreement that was supposed to prevent Donald’s client, *ABC*, from competing against *XYZ* for five years. The non-compete agreement was materially different from the one that Alexandra and Donald negotiated. Donald knows how anxious *XYZ* is to close the deal and that Alexandra will likely sign almost anything.

Should Alexandra sign the non-compete agreement?

Yes, because both *XYZ* and Joe gave her the authority to do so.

No, because it is against *XYZ*’s best interest and she should confirm the decision with *XYZ* first.

No, she should refuse to sign the document and request that Donald provide her with the proper agreement.

If Alexandra signs the non-compete agreement because Joe told her to, and the client is unhappy with that decision, is Alexandra susceptible to disciplinary action?

Yes, because though she may have acted in accordance with Joe’s wishes, she is still bound by the Rules of Professional Conduct.

No, because she acted in accordance with Joe’s decision which was based on the client’s wishes and therefore it was a reasonable.

Inequality and Bias (Video)

What should the female lawyer have done in response to the male lawyer’s comments?

Kindly and calmly inform the lawyer that the scope of her question is proper under the circumstances and request that the witness answer the question.

Ignore the male lawyer’s comments and simply explain the deposition process to the deponent.

Explain to the male lawyer that his comments are inappropriate and unprofessional.

Should the female lawyer report the male lawyer?

Yes, the female lawyer should report the male lawyer's conduct to the senior partner. No, the female lawyer should handle the issue herself and not involve anyone else. Yes, the female lawyer should report the male lawyer's conduct to the bar association. No, because the male lawyer cannot be punished for bias.

"Ethics is knowing the difference between what you have the right to do and what is right to do"

– Hon. Potter Stewart

Friday, March 1, 2019
9:15 – 10:15 pm

Concurrent Session B

Current Issues in Complex Commercial Mortgage Finance Transactions: How to Get Everything You Ever Wanted Without Trying Too Hard

MODERATOR

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Louisville, K

CURRENT MARKET CONDITIONS

- CMBS Lenders
- CLO Lenders
- REIT and other Fund Lenders
- Commercial Banks
- Life Insurance Companies

TRANSFER RESTRICTIONS; ADDITIONAL FINANCING

- Permitted Transfers
  a. Estate Planning
  b. JV-Level buy-outs
- Additional Financing – Unlikely to get, do see some permitted future mezz-loans negotiated on value – add deals and permitted equipment financing on certain assets

TRANSFERS:
PERMITTED TRANSFERS

STANDARD PROVISION

- Without the prior written consent of Lender…Borrower shall not, and shall not permit any Restricted Party [owners of direct or indirect interests in the Borrower] to do any of the following (collectively, a "Transfer"): (i) sell, convey, mortgage, grant, bargain, encumber, pledge, assign, grant options with respect to, or otherwise transfer or dispose of (directly or indirectly, voluntarily or involuntarily, by operation of law or otherwise, and whether or not for consideration or of record) the Property or any part thereof or any legal or beneficial interest therein or (ii) permit a sale or pledge of an interest in any Restricted Party, other than (A) pursuant to Leases of space in the Improvements to Tenants in accordance with the provisions hereof and (B) Permitted Transfers.

NEGOTIATED PROVISION

- Without the prior written consent of Lender…Borrower shall not, and shall not permit any Restricted Party [owners of direct or indirect interests in the Borrower] to do any of the following (collectively, a "Transfer"): (i) sell, convey, mortgage, grant, bargain, encumber, pledge, assign, grant options with respect to, or otherwise transfer ordispose of (directly or indirectly, voluntarily or involuntarily, by operation of law or otherwise, and whether or not for consideration or of record) the Property or any part thereof or any legal or beneficial interest therein or (ii) permit a sale or pledge of an interest in any Restricted Party, other than (A) pursuant to Leases of space in the Improvementsto
  Tenants in accordance with the provisions hereof and, (B) Permitted Transfers., (C) Estate Planning Transfers, or (D) Permitted Conditional Transfers.

- "Estate Planning Transfer" shall mean any inter vivos or testamentary Transfer by a Person of all or any portion of the direct or indirect beneficial ownership interest in a Restricted Party to (a) one or more immediate family members of such Person, (b) a trust or other entity in which all the beneficial interest is held by such Person or one or more immediate family members of such Person, or (c) a charitable organization; provided, that in each case (i) such Transfer is made in connection with such Person's bona fide, good faith estate planning, (ii) such Transfer does not result in a change in control of Borrower, (iii) no such Transfer has an adverse effect on the bankruptcy remote status of Borrower, and Borrower provides to Lender thirty (30) days prior notice of any such inter vivos Transfer and thirty (30) days' notice after any such testamentary Transfer together with reasonably satisfactory evidence of satisfaction of the foregoing conditions.

- "Permitted Conditional Transfer" shall mean a transfer by a Restricted Partyof its direct or indirect ownership interest in Borrower to any Person; provided, however, that any such transfer shall be subject to the following conditions precedent:
  1) If the transfer results in transferee owning more than 20% of the Borrower, prior notice must be provided to lender of the proposed transfer (unless transfer is caused by death or incapacity, in which case, Lender must be provided notice 30 days after such death or incapacity).
  2) If the transfer results in transferee owning more than 20% of the Borrower, (i) lender must receive Satisfactory Search Results and (ii) the transferee must satisfy the lender's "know your customer" requirements;
  3) at all times following such transfer, the nonrecourse careveout guarantor shall continueto control Borrower.

GRANTING OF UTILITY EASEMENTS

STANDARD PROVISION

Borrower shall not Transfer (or grant any rights in) the Property, without the consent of LenderNEGOTIATED PROVISION

Borrower shall not Transfer (or grant any rights in) the Property, without the consent of Lender. Notwithstanding the foregoing, Borrower shall be permitted, without the consent of Lender:

(i) to make immaterial Transfers of unimproved, non-income producing portions of the Property that was given no value in the appraisal delivered in connection with the closing of the Loan to Governmental Authorities for dedication or public use provided that no such transfer, conveyance or encumbrance set forth in the foregoing clause shall materially impair the utility and operation of the Property or reasonably be expected to, or does, have a Material Adverse Effect; and

(ii) to grant easements, restrictions, covenants, reservations and rights of way in the ordinary course of business for access, water and sewer lines, telephone or other fiber optic or other data transmission lines, electric lines or other utilities or for other similar purposes, provided that no such transfer, conveyance or encumbrance set forth in the foregoing clause shall materially impair the utility and operation of the Property or reasonably be expected to, or does, have a Material Adverse Effect.

EXIT STRATEGIES

a. Prepayment – Limited negotiability on CMBS, CLO and fund deals,greater flexibility with commercial banks and life insurance companies
b. Defeasance
c. Substitution of Collateral - Very difficult from our experience, unless significant sponsor and likely un-securitized loan product
d. Partial Releases –Very common and reasonable for shopping centers, but must ask for upfront and get clearly detailed; if CMBS then a loan-to-value test will be included based upon current REMIC regulations, even if out parcel is not producing any revenue at closing

DEFEASANCE

- Attempt to expand definition of defeasance collateral to include agency securities
- Limit scheduled defeasance payments to stop on first day of open period
- Permit Borrower to designate the successor Borrower so Borrower may be able to negotiate a share of any residual value of securities.

DEFAULT AND REMEDY PROVISIONS

- Always focus on pushing days back
- Attempt to delete any specific defaults that cross-reference sections of the loan documents that are not as essential to lenders so "catch-all" provisions, pick them up

EVENTS OF DEFAULT-DEBT PAYMENTS AND PROPERTY MANAGER

STANDARD PROVISION

- It shall be deemed an Event of Default:
  a. If any portion of the outstanding debt is not paid when due
  b. If a default has occurred and continues beyond any applicable cure period under the Property Management Agreement if such default permits the Property Manager thereunder to terminate or cancel the Property Management Agreement.

NEGOTIATED PROVISION

- It shall be deemed an Event of Default:
  a. If any portion of the outstanding debt is not paid when due; provided, however, with respect to any failure by Borrower to pay any regularly scheduled Debt Service Payment when due, and up to one (1) time during any twelve (12) month period and provided that Lender shall not be required to provide notice of any delinquent payments, Borrower shall have five (5) days in which to cure such Event of Default, after which time Lender may, at its option, exercise any of its rights and remedies available to it at law or in equity.
  b. If a default has occurred and continues beyond any applicable cure period under the Property Management Agreement if such default permits the Property Manager thereunder to terminate or cancel the Property Management Agreement) and the Property Manager is not replaced pursuant to a Replacement Management Agreement within thirty (30) days after the expiration of applicable cure

=

periods.

EVENTS OF DEFAULT:
BREACH OF NON-ENUMERATED COVENANTS ("CATCH ALL")
STANDARD PROVISION

- It shall be deemed an Event of Default:
  a. if Borrower shall continue to be in Default under any of the other terms, covenants or conditions of the loan agreement not specified as an Event of Default hereunder, for ten (10) days after notice to Borrower from Lender for monetary defaults, or for thirty (30) days after notice from Lender in the case of any other Default; provided, however, that if such non-monetary Default is susceptible of cure but cannot reasonably be cured within such thirty (30) day period and provided further that Borrower shall have commenced to cure such Default within such thirty (30) day period and thereafter diligently and expeditiously proceeds to cure the same, such thirty (30) day period shallbe extended for such time as is reasonably necessary for Borrower in the exercise of due diligence to cure such Default, such additional period not to exceed sixty (60) days.

NEGOTIATED PROVISION

- It shall be deemed an Event of Default:
  a. if Borrower shall continue to be in Default under any of the other terms, covenants or conditions of the loan agreement not specified as an Event of Default hereunder, for ten (10) days after notice to Borrower from Lender for monetary defaults, or for thirty (30) days after notice from Lender in the case of any other Default; provided, however, that if such non-monetary Default is susceptible of cure but cannot reasonably be cured within such thirty (30) day period and provided further that Borrower shall have commenced to cure such Default within such thirty (30) day period and thereafter diligently and expeditiously proceeds to cure the same, such thirty (30) day period shallbe extended for such time as is reasonably necessary for Borrower in the exercise of due diligence to cure such Default, such additional period not to exceed sixty (60)ninety (90) days.

NONRECOURSE CARVEOUTS: LOSSES
STANDARD PROVISION
Borrower shall be personally liable to Lender for the Losses it incurs arising out of or in connection with the following:

- material physical waste of the Property.
- failure to pay charges for labor or materials or other charges or judgments that can create liens on any portion of the Property.

NEGOTIATED PROVISION
Borrower shall be personally liable to Lender for the Losses it incurs arising out of or in connection with the following:

- material physical waste of the Property caused by acts or omission of Borrower; provided, however, there shall be no liability for physical waste if such occurs duringa time when there was insufficient available cash flow to prevent such waste.
- failure to pay charges for labor or materials or other charges or judgments that can create liens on any portion of the Property; provided, however, that unless Borrower incurred such charges after the occurrence and during the continuance of an Event of Default, there shall be no liability for such failure to pay if it occurs during a time when there was insufficient available cash flow to prevent such failure to pay.

STANDARD PROVISION
Borrower shall be personally liable to Lender for the Losses it incurs arising out of or in connection with the following:

- (i) the misappropriation, misapplication or conversion by Borrower of any Rents following an Event of Default or (ii) any Rents paid more than one month inadvance.
- the gross negligence or willful misconduct of Borrower.

NEGOTIATED PROVISION
Borrower shall be personally liable to Lender for the Losses it incurs arising out of or in connection with the following:

- (i) the misappropriation, misapplication or conversion by Borrower of any Rents following an Event of Default (provided, however, that the application of Rents to reasonable and customary Operating Expenses or to Extraordinary Expenses approved by Lender in accordance with this Agreement shall not be considered misapplication, misappropriation or conversion), or (ii) any Rents paid more than one month in advance.

- the gross negligence or willful misconduct of Borrower; provided, however, Borrower's failure to perform any obligation under the loan documents shall not be construed as gross negligence or willful misconduct if Borrower is required to expend any sum of money in order to perform the obligation in question and there was insufficient available cash flow to allow Borrower to perform the obligation.

FULL RECOURSE
STANDARD PROVISION
The debt shall be fully recourse to Borrower in the event of:

- Borrower filing an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other Person under the Bankruptcy Codeor any other Federal or state bankruptcy or insolvency law.
- Borrower making an assignment for the benefit of creditors, or admitting in writing orin any legal proceeding, its insolvency or inability to pay its debts as they become due.
- if Borrower fails to maintain its status as aSpecial Purpose Entity or comply with any of the Special Purpose Entity representations, warranties or covenants contained in the Loan Documents.

NEGOTIATED PROVISION
The debt shall be fully recourse to Borrower in the event of:

- Borrower filing an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other Person under the Bankruptcy Code or any other Federal or state bankruptcy or insolvency law; provided, however, Borrower may acquiesce or file an answer consenting to any such action if brought by Lender.
- Borrower making an assignment for the benefit of creditors, or admitting in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due.
- if Borrower fails to maintain its status as a Special Purpose Entity or comply with any of the Special Purpose Entity representations, warranties or covenants contained in the Loan Documents and such failure is cited as a factor in connection with a substantive consolidation of the assets or liabilities of Borrower with those of any other Person.

FULL RECOURSE
STANDARD PROVISION
The debt shall be fully recourse to Borrower:

- if Borrower fails to obtain Lender's prior written consent to any additionalindebtedness.
- If Borrower shall fail to obtain Lender's prior written consent to any transfer asrequired by the Loan Documents.

NEGOTIATED PROVISION
The debt shall be fully recourse to Borrower:

- if Borrower fails to obtain Lender's prior written consent to any additional indebtedness (other than indebtedness expressly permitted by this Agreement); provided, however, that there shall not be recourse liability for failure to pay trade payables, provided that such trade payables were reasonable and customary and entered into the ordinary course of business with a third party on market terms, and such failure to pay trade Payables is due to insufficient available cash flow revenue from the Property to allow Borrower to pay the trade payable.
- If Borrower shall fail to obtain Lender's prior written consent to any transfer as required by the Loan Documents of the following Transfers unless such transfer is a Permitted Transfer, Estate Planning Transfer or Permitted Conditional Transfer: (A) any voluntary granting of a mortgage or other lien upon the Property, or (B) any voluntary Transfer which results in a failure to comply with the requirement for the Guarantor or other Restricted Parties to control Borrower.

SPECIAL PURPOSE ENTITY COVENANTS: SOLVENCY
STANDARD PROVISION

- Borrower shall not become insolvent and fail to pay its debts and liabilities (including,as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.

NEGOTIATED PROVISION

- Tothe extent the Property produces sufficient revenue, Borrower shall not become insolvent and fail to pay its debts and liabilities (including, as applicable, sharedpersonnel and overhead expenses) from its assets as the same shall become due; provided, however, nothing shall obligate the direct or indirect owners of Borrower to make capital contributions to Borrower or to otherwise advance funds to Borrower in order to be in compliance with the requirements contained herein.

CASUALTY/CONDEMNATION

a. Borrower should have the right to adjust insurance claims under a specified amount. The threshold will vary by loan amount.
b. Borrower should not be required to provide written notice to Lender of any casualty under a specified amount.
c. Lender should agree to apply insurance and casualty proceeds to restoration so long as (a) there is no Event of Default, (b) leases exceeding a specified threshold shall not be terminated, (c) restoration will not take longer than a specified time complete, and (d) restoration will be completed prior to the last year or last 18 months of the term.
d. Borrower should have the right to participate in condemnation proceedings unless there is an ongoing Event of Default.
e. No prepayment penalty should apply if condemnation or casualty proceeds are applied to the loan.

REPRESENTATIONS, WARRANTIES AND COVENANTS

- Compliance with Laws: Any representation and/or covenant to comply with legal requirements should have a materiality qualifier. Any representation should also have a knowledge qualifier. Borrower should have the right to contest legal requirements and taxes.
- Liens: Borrower should have the right to contest liens.
- Restrictive Covenants; Zoning: Borrower should have the right to subject the property to restrictive covenants that are normal and customary and that do not adversely affect the lien of the Mortgage. Borrower should have the right to consent to a zoning change in the ordinary course of business. Any representation as to zoning should have a knowledge qualifier and should refer to the zoning report, if any.
- Other Contracts (not leases): Any representation as to defaults under contracts should have a knowledge qualifier and a materiality qualifier. Lender's consent rights as to other contracts, if any, should be limited to "Material Agreements."
- Litigation: Representations as to litigation should exclude anything covered by insurance or that would not materially affect the Borrower or the Property.
- Alterations: Borrower should have the right to make alterations up to a specified amount without Lender's consent. The threshold will vary by loan amount.
- Environmental:
  a. All environmental representations should have a knowledge qualifier and a materiality qualifier and should except anything disclosed on the environmental reports.
  b. Lender's right to conduct environmental investigations at Borrower's cost should apply only during an Event of Default or when the investigation shows that there are violations of environmental laws.
  c. Borrower's environmental indemnification should not apply to (i) events occurring after the loan is paid or Lender takes possession of the property or (ii) conditions that arise out of an affirmative act of Lender.
  d. Borrower's environmental indemnification should expire one year after the expiration of the loan terms.

LEASE APPROVALS:
LENDER CONSENT AND DEEMED APPROVAL
STANDARD PROVISION

- All proposed Leases which are not (i) renewals of existing leases (a "Renewal Lease") or (ii) Leases for space which covers more than [x] square feet ("Major Leases") shall be subject to the prior written consent of Lender.

NEGOTIATED PROVISION

- All proposed Leases which are not (i) renewals of existing leases (a "Renewal Lease") or (ii) Leases for space which covers more than [x] square feet ("Major Leases") shall be subject to the prior written consent of Lender, not to be unreasonably withheld, conditioned or delayed. To the extent Lender's approval is required for any Renewal Lease or Major Lease, Borrower's written request therefor shall be delivered together with such materials reasonably requested by Lender in order to evaluate such request. Each such request shall conspicuously state, in large bold type on the top of the first page of such request, the purpose for the notice, and the time [usually ten (10) Business Days] within which Lender is required to respond. In the event Lender fails to approve or disapprove to such initial request within [ten (10) Business Days] of the effective date of such initial request, Borrower may deliver to Lender a second written request for approval, which second written request for approval shall conspicuously state the purpose of such notice and the time [usually five (5) Business Days] within which Lender is required to respond. In the event that Lender fails to approve or disapprove the second written request within such [five (5) Business Day period], then Lender's consent shall be deemed to have been granted.

LEASING ISSUE: ALTERATIONS - LENDER CONSENT
STANDARD PROVISION

- Borrower shall obtain Lender's prior written consent to any alterations to any Improvements, which consent shall not be unreasonably withheld or delayed except with respect to alterations that may have a material adverse effect on Borrower's financial condition, the value of the Property or the Property's Net Operating Income.

NEGOTIATED PROVISION

- Borrower shall not be required to obtain Lender's prior consent to any alterations to any Improvements that at any time do not exceed $250,000, provided the alterations (i) do not have a material adverse effect on Borrower's financial condition, the value of the Property or the Property's Net Operating Income, (ii) are non-structural, and (iii) donot change the building footprint. Otherwise, Borrower shall obtain Lender's prior written consent to any alterations to any Improvements, which consent

PROPERTY MANAGEMENT

- If Lender has the right to approve a replacement property manager, consider including "Qualified Manger" definition, such as: A Qualified Manager shall mean a reputable and experienced management company which manages, together with its Affiliates, at least 5 other properties similar to the Property and which, in the aggregate, consist of at least 5,000,000 square feet of gross leasable area (including all anchor space), exclusive of the Property.
- Avoid Lender rights to terminate the property manager without cause or to decrease or eliminate compensation to property manager.
- The property manager should not be required to pay back any amounts received under the management agreement.
- The property manager should not be required to work for free; Lender should acknowledge property manager's right to terminate the management agreement in the event management fees are not paid.

CASH MANAGEMENT AND RESERVES

- Very much dependent on loan type.
- Securitized products have limited flexibility and lock boxes should be anticipated on retail deals.
- Negotiations should focus on when "cash management" is triggered and when releases occur, particularly following key tenant closures and replacements.

FINANCIAL REPORTING

- Financial reporting requirements should be reviewed by Borrower's accounting group.
- Audited financial statements should be required only if Borrower customarily has them prepared. If Lender has the right to approve a CPA, consider obtaining preapproval.
- Review the timing to provide monthly, quarterly and annual reports for practicality.
- Consider having Lender preapprove the form of reports.
- Any representations as to financial reports should have a materiality qualifier.

SECONDARY MARKET TRANSACTIONS

- Post-closing costs can be negotiated, if Lender won't agree to pay they may agree to a cap on costs.
- Be careful for impossible requirements like audited financials being triggered for a smaller company.

Friday, March 1, 2019
10:30 – 11:30 am

Concurrent Session A

Cannabidiol (CBD):
A new opening for Landlords in the cannabis industry?

MODERATOR

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REAL ESTATE AND MARIJUANA: FINANCIAL OPPORTUNITY OR UNMANAGEABLE RISK?

Setting the Stage – The Ever-Changing Legal Landscape of Medical and Recreational Marijuana Businesses

Before discussing the legal commercial real estate issues related to marijuana businesses, it is worthwhile to note the current business landscape which, despite the legal issues described below, is growing dramatically and shows no signs of slowing. Even if near-term growth diminishes under the new administration, the long-term prognosis for the industry is strong.

> **"Commercial real estate developers say they have never seen a change so swift in so many places at once. From Monterey, California to Portland, Maine, the new industry is reshaping once blighted neighborhoods and sending property values soaring in some Denver neighborhoods, the average asking lease price for warehouse space jumped by more than 50% from 2010 to 2015, according to an industry report. In the city overall, there are five times as many retail pot stores as stand-alone Starbucks shops."** ***New York Times*, *Sunday, April 2, 2017***

The sharp rise in property prices follows the booming market for legal marijuana. Sales of legal cannabis reached $6.7 billion in the United States last year and are expected to top $20 billion by 2021, according to ACRVIEW Market Research.

The April 2 *New York Times* article describes the market in Denver, Colorado as follows:

> **"Denver has emerged as America's *de facto* pot capital. Since Colorado legalized marijuana for recreational use in 2012, hundreds of stores selling pot have opened and enormous growing operations have set up shop. Legal cannabis sales topped $1 billion in the state last year. From 2009-2014, 36% of new industrial tenants were marijuana businesses, according to the report on the city from CBRE Research, a commercial real estate company. Nearly four million square feet of industrial space was being used for cultivation in 2015 according to the report, about 3% of the city's warehouse space. Retail spaces are just as hot. By 2015, there were upward of 200 marijuana stores in Denver, occupying high-end storefronts and former gas stations. The spike in demand has been good for landlords, who often charge 2-3 times market rates for spaces used for cultivation or sales."**

The last sentence in the quote above signals why, notwithstanding perceived federal legal hurdles, marijuana business leasing is increasingly likely to cross the desks of lawyers across the country (or at least in 29 out of 50 states, as of today). In a real estate market depressed by falling demand for retail space, how long will it be before marijuana stores have a presence in strip malls and regional centers? An interesting real estate market note: because marijuana is still illegal federally (as discussed below), all marijuana to be sold in a state where it is legal must be grown in the same state. Crossing state lines with marijuana grown in another state violates federal law. As a result, the demand for warehouse space in Denver is as high as noted above. Presumably, this is also the case in other northern states where medical or recreational marijuana is legal but outdoor growing conditions are less than ideal. When federal law ultimately allows sale and use of medical and recreational marijuana, the "crossing state lines" issue will disappear and cultivation in more climatically accommodating states (e.g., California) will explode, while demand for warehouses in those northern states should decrease.

The April 2 *New York Times* article goes further to describe the nature of the current retail marijuana outlets.

> **"A short drive away in Brookline, the store in an old Beaux Arts bank was also doing a brisk business … the [retailer] wanted some pizazz for the customer experience, so it leased a bank. Inside, skylights and tall arched windows flood the former bank lobby with sunlight. Gilded Corinthian columns reach up to a domed turquoise ceiling. Where bank tellers once handed out cash, employees now hand over buds of Tangerine Haze and Master Kush. The decision to lease the former bank wasn't cheap for the [retailer]. The group entered into a lease years ago and paid rent while it sat empty. 'The holding costs there were significant,' said Norton Arbelez, Director of Government Affairs for the [retailer]. But, Mr. Arbelez said, 'we wanted to take this industry out of the shadows' and a flashy retail space was one way to make that happen. So far, it seems to be working. On a busy day, the [retailer] can sell**

> **marijuana buds, pre-rolled joints and cannabis infused chocolates worth as much as $100,000."**

Currently, marijuana is legal for medical purposes in 29 states and the District of Columbia, and in eight states and the District of Columbia (Colorado, Washington, Oregon, Arkansas, California, Nevada, Massachusetts and Maine) for recreational use. In addition to outright legalization, there are decriminalization statutes in other states. Few predict a reversal of this trend toward legalization at the state level and many believe, ultimately, at the federal level.

A Brief Overview of Federal Legality and Illegality Issues

Under the 1970 Controlled Substances Act (21 U.S.C. § 800 *et seq*.), marijuana is listed as a Schedule 1 drug. Schedule 1 drugs are considered the most dangerous. Its current federal status puts marijuana in the same category as heroin, cocaine and opium, in sharp contrast to its legality in the early 1900s. Of particular interest to commercial property owners is 21 U.S.T.C. § 856 (the "crack house statute") which provides that using or allowing real property to be used for unlawfully manufacturing, storing, distribution, or using a controlled substance is a federal crime, the penalty for which may include forfeiture. It is the fear of breaking federal law and, potentially, losing their property that quite logically has made landlords reluctant to lease to marijuana businesses even in states where it is legal.

Supremacy Clause

The supremacy clause of the U.S. Constitution (U.S. Constitution Article 6, Clause 2) provides that the federal law is the supreme law of the land and, as a result, the federal laws criminalizing marijuana use and sale preempt any state statute legalizing use. It is beyond the scope of this article to discuss potential arguments for exclusion from the preemption clause, but for purposes of this article, it will be assumed that federal preemption is in effect and unchanged. Federal preemption would appear to freeze in its tracks any state efforts to legalize marijuana. If so, why is the marijuana business currently a multi-billion dollar business, and growing? The answer lies in the prior administration's approach to enforcement of the Controlled Substances Act with respect to marijuana.

The two seminal federal actions relaxing the impact of preemption are the Cole Memorandum and the Rohrabacher Farr Amendment.

The Cole Memorandum

The Cole Memorandum is a U.S. Department of Justice memorandum dated August 29, 2013, issued under the Obama administration by James M. Cole, Deputy Attorney General. The title of the subject memorandum is "Guidance Regarding Marijuana Enforcement." The Cole Memorandum was intended to provide guidance to federal prosecutors regarding enforcement of marijuana laws under the Controlled Substances Act in the aftermath of growing state legalization of medical and recreational marijuana use. Paying lip service to the fact that marijuana remains a Schedule 1 controlled substance and, therefore, possession and use constitutes a federal crime, the Cole Memorandum states, "the Department [of Justice] is … committed to using its limited investigative and prosecutorial resources to address the most significant threats in the most effective, consistent and rational way." In effect, the Cole Memorandum states that enforcement of marijuana laws is not the highest Department of Justice priority. The Cole Memorandum highlights the enforcement priorities which the Department of Justice has with respect to marijuana, and these priorities are as follows:

> "Preventing the distribution of marijuana to minors;
>
> Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs and cartels;
>
> Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
>
> Preventing state authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
>
> Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
>
> Preventing drug driving and the exacerbation of other adverse public health consequences associated with marijuana use;

Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and

Preventing marijuana possession or use on federal property."

The Cole Memorandum directs federal prosecutors to direct their prosecution efforts only to the categories described above. The Cole Memorandum notes that, traditionally, enforcement of marijuana laws with respect to small quantities has been left to the states. The Cole Memorandum also assumes that in those states where legalization exists, the states will otherwise implement regulatory enforcement systems to protect the public safety and public health. The Cole Memorandum concludes with this direction to prosecutors: "The primary question in all cases – and in all jurisdictions – should be whether the conduct at issue implicates one or more of the enforcement priorities listed above." As is obvious from the description of the priorities in the Cole Memorandum, medical and recreational marijuana cultivation and retail sale, as contemplated by state laws, can be undertaken without violation of the priorities listed in the Cole Memorandum and, therefore, seemingly without risk of Federal prosecution. It should be noted, however, that the Cole Memorandum is a directive by a Deputy to prosecutors in the Department of Justice and is not a federal law or regulation. At the risk of stating the obvious, it should also be noted that the Cole Memorandum was drafted and distributed under the Obama administration and, given the recent change in administrations and priorities, there is a risk that the Cole Memorandum could be withdrawn or modified by Attorney General Sessions.

To date, the authors are unaware of any such withdrawal or other memorandum addressing this issue from the current administration. With regard to enforcement of federal marijuana laws under the new administration, the following quote from Attorney General Sessions on April 5, 2016, is worth noting:

> "We need grownups in charge in Washington to say marijuana is not the kind of thing that ought to be legalized. It ought not to be minimized, that it's in fact a very real danger."

<u>Rohrabacher Farr Amendment</u>

In addition to the comfort afforded by the Cole Memorandum, marijuana users and retailers have also looked to a rider to the federal consolidated appropriations acts commencing in 2014 and continuing through 2017, which provided in § 537 of the Consolidated Appropriations Act of 2017 that "none of the funds made available in this Act to the Department of Justice may be used with respect to any of the states [and the states legalizing medical and recreational marijuana are listed] to prevent any of them from implementing their own laws that authorize the use, distribution, possession or cultivation of medical marijuana." The Department of Justice cannot use appropriated funds to enforce federal marijuana laws.

The Cole Memorandum, which advises Department of Justice prosecutors not to enforce federal marijuana laws unless they violate one of the priorities, coupled with the Rohrabacher Farr Amendment language withholding appropriations to fund implementation and enforcement of federal marijuana laws in states where use is legal has given comfort to the marijuana wholesale and retail industry. It should be noted that the Rohrabacher Farr Amendment has a sunset of September 30, 2017. It is unclear, given the current Congress and administration, whether the Rohrabacher Farr Amendment will be continued for a fourth year. It is against this backdrop of non-legally binding federal disinclination to enforce that the marijuana wholesale and retail industry has exploded in the United States.

<u>Other Federal Issues</u>

There are other federal law issues relating to the operation of a marijuana retail facility which are beyond the scope of this article, but are worth noting in passing.

<u>IRS/Taxes</u>

With respect to business expenses and, more particularly, deduction of business expenses incurred by a marijuana retail operator, I.R.C. § 280(E) prohibits deduction of expenses from a trade or business on federal tax returns. The inability to deduct such expenses, including lease payments, obviously has a significant impact on profitability of retail marijuana outlets and effectively means marijuana stores pay higher taxes than other retailers.

Department of Treasury/Banking

There are significant issues under federal law with respect to banking and marijuana retail facilities. As noted above, the volume of money changing hands in retail sales was estimated to be $6.7 billion in 2016. Both Department of the Treasury regulations and case law (*Fourth Corner CU v. Federal Reserve Bank of Kansas City*, District Court Colorado 15-CB-01633) (2016) hold that banks cannot facilitate criminal activity; therefore, because possession and sale of marijuana is illegal, under federal law, banks cannot accept deposits from marijuana wholesalers and retailers. As a result, retail marijuana businesses are cash-only businesses. Because of the volume of money involved, the safety and security issues surrounding a retail marijuana business are significant. Because of the cash-intensive nature of the business, marijuana business owners are also subject to suspicious activities reports (SARs) under the Financial Crimes Enforcement Network ("FinCEN") regulations, which provide that cash deposits in excess of $10,000 must be disclosed to FinCEN.

FinCEN has issued regulations with respect to marijuana-related businesses. A Department of the Treasury FinCEN Guidance was issued on February 14, 2014 regarding treatment of marijuana-related businesses. The basis of the Department of Treasury FinCEN Guidance is the Cole Memorandum. If the current administration reverses the Cole Memorandum, the validity of the Department of Treasury FinCEN Guidance will come into question.

The following is a summary of the FinCEN Guidance due diligence requirements for banks wishing to open accounts with marijuana businesses: As a precondition to opening accounts and conducting business with a marijuana related business, banks are required to (a) verify with state authorities that the business is duly-licensed and registered; (b) review the license application related documentation; (c) request state licensing and enforcement authorities to provide information regarding the business; (d) develop an understanding of the activity of the business, including types of products sold and type of customers to be served; (e) on an ongoing basis, monitor publicly available sources for adverse information regarding the party; (f) conduct ongoing monitoring for suspicious activity; and (g) update due diligence materials on a regular basis. Part of the due diligence described requires determining whether the business violates the Cole Memorandum priorities.

In the unlikely event that a financial institution agrees to undertake the above-described due diligence requirement, and open a bank account with a marijuana business, that institution will also be required to file suspicious activity reports ("SARs") for its client's deposits. Applicable federal regulations require SARs to be filed whenever a financial institution receives funds from a criminal activity. Because marijuana businesses are illegal, SARs must be filed with respect to all marijuana business deposits. Red flags described by the Treasury which require special SARs and, potentially, greater due diligence include, without limitation, (a) use of a state licensed marijuana-related business as a front for money laundering; (b) receipt by the business of substantially more revenue than may be reasonably expected; (c) the business receives more revenue than its competitors; (d) the business is depositing more cash than commensurate with revenue reported for tax purposes; (e) inability to document income is derived only from marijuana and not from sale of other drugs; (f) excessive deposits or withdrawals relative to competitors; (g) deposits believed to be structured to avoid currency transaction reports ("CTRs"); (h) rapid movement of funds, cash in and cash out; (i) third party deposits unrelated to the account holder; (j) commingling of funds with personal accounts; (k) transactions appearing to be on behalf of undisclosed third parties; (l) financial statements inconsistent with actual account activity; and (m) surges by third parties offering goods and services. Other areas which financial institutions are required to red flag include failure of the business to produce satisfactory documentation of licensing; efforts of marijuana-related businesses seeking to conceal or disguise their operation; due diligence revealing "negative information" such as criminal record, involving in illegal purchase of drugs, violence and other potential connections to illicit activity.

Given the Treasury regulations, it is no surprise that marijuana businesses are cash only and do not involve the use of customary banking arrangements.

Trademark/Patents

Trademarks are only permitted with respect to lawful commerce. As a result, registration of trademarks relating to sale of marijuana are not permitted.

Bankruptcy

Relief under federal bankruptcy laws is not available to marijuana businesses which are insolvent (*in re* Arenas (Bankruptcy District Colorado (2014)). In addition, there is also a Department of Justice letter dated April 26, 2017 directed to bankruptcy trustees, stating "it is the policy of the U.S. that Trustees shall move to dismiss or object to all cases involving marijuana assets."

Recent Cases

Safe Streets Alliance v. Alternative Holistic Healing, LLC

Background: In two separate actions, landowners and Colorado, Kansas, and Nebraska law enforcement officials challenged Amendment 64 to Colorado Constitution, which repealed criminal and civil proscriptions on recreational marijuana, as preempted by federal Controlled Substances Act (CSA), and brought Racketeer Influence and Corrupt Organizations Act (RICO) action against marijuana growers on adjacent property. The United States District Court for District of Colorado, Robert E. Blackburn, J., 2016 WL 233815, dismissed landowners' claims. Landowners and law enforcement officials appealed. States of Nebraska and Oklahoma moved to intervene in both actions, which was granted in landowners' action.

LEASE ISSUES AND MODEL CLAUSES

Leasing to a state-licensed marijuana facility is fraught with complexity. Notwithstanding a facility's full compliance with state and local law, landlords and tenants entering into leases for the operation of a marijuana facility are advised to consider and address the unique aspects of these leasing relationships when drafting their leases.

From a landlord or property owner perspective, the ability to charge above-market lease rates to marijuana-related tenants, as compared to other non-marijuana related tenants, is a significant inducement. It is not uncommon for marijuana lease rates to be two to three times more than the leasing rates charged to other tenants in the same building or real estate market; however, this market rate differential may not be so prevalent in cities where marijuana retails sales have become a competitive business. Retail prices have decreased in cities, like Denver, where there is an abundance of supply.

For some landlords and property owners, the day-to-day difficulties and elevated financial (and criminal) risk associated with leasing to a marijuana-related business outweigh the lucrative leasing rates. Most notably, because marijuana continues to be listed as a Schedule I drug under the federal Controlled Substances Act, property owners leasing to marijuana-related businesses expose themselves to the Civil Asset Forfeiture Reform Act of 2000. Under the Act, any real property that is associated with violations of the Controlled Substances Act may be seized and the subject property owners imprisoned. Enforcement of the forfeiture laws is largely dependent upon the nature of the underlying marijuana operations, and the federal government's propensity to enforce such violations, which, under the current administration, remains unclear.

The key to leasing to a marijuana-related business is incorporating specific marijuana leasing provisions that mitigate the criminal, financial, and operational risks. The following lease provisions should be considered by both landlords and tenants during the negotiation and drafting of a retail dispensary lease.

Permitted Use

Property owners and tenants should first address what the tenant's anticipated use of the premises will be. Landlords should ensure that the tenant obtains the appropriate state and local licenses and permits for a marijuana-related business, maintains such licenses and permits in good standing and provides proof of good standing on an ongoing basis. The lease should limit the permitted use to that which is allowed by the tenant's state-issued, and in certain jurisdictions locally-issued, licenses and permits, as they may be amended or changed by the applicable state-regulating authority.

Lease Example for Permitted Use

> *"The Premises shall be used by Tenant to carry out a lawful cannabis business in accordance with [insert relevant state marijuana law and regulations] for the following uses that Landlord has initialed next to the listed item and for no other purposes. [List agreed upon permissible uses, including whether recreational sales are permitted]."*
>
> *"This is a nonsmoking premises. No smoking, including medical or recreational marijuana, inside or on the Premises is permitted. However, consuming medical marijuana with a vaporizer or in cannabis edibles, tonics, or concentrates is permitted."*
>
> *"No recreational or medical marijuana may be consumed on the Premises by the Tenant(s) or Tenant's guests and invitees without the prior written consent of the Landlord."*

"Unless otherwise consented to by Landlord, in writing, Tenant shall be prohibited from operating a recreational or adult use marijuana dispensary on the Premises, regardless of state law."

"Tenant shall at all times during the term of the Lease or any extensions thereof, have a copy of Tenant's state-issued marijuana license at the Premises and shall be available during working hours to present such license, which shall be in good standing with the applicable state governmental regulating authority. Upon each renewal of Tenant's state-issued marijuana license, Tenant shall provide a copy of such license to Landlord within twenty-four (24) hours of receipt."

A lease should specifically describe the activities that may occur on the premises. A landlord may want to limit those activities to those that align with the specific type of license the business possesses. A landlord may also want to restrict or forbid the use of any marijuana products on the premises. Tenants should be required to diligently monitor employees, patients, customers, invitees and agents to ensure that no product is used on the premises contrary to the permitted use.

<u>On-Site Cash</u>

For security purposes, the lease should limit the amount of cash a tenant is allowed to keep on the premises. For example, a lease may limit the amount of cash a tenant is allowed to keep on hand at any given time or may require the tenant to remove cash reserves from the premises at the end of each day. Landlords should also consider requiring a reputable armored cash transfer service for the movement of all cash and restricting the tenant's ability to have an ATM on the premises.

<u>Lease Example</u>:

"Tenant shall use its best efforts to ensure that patients, customers, employees, agents, and owners of Tenant and Tenant's dispensary neither loiter, nor use, smoke, vape, dab, consume, in any form or fashion, any THC and/or CBD marijuana product in the Premises or Building, on the Property or in any adjacent properties. Tenant shall remove cash from the Premises at the end of each day, so that at no time shall Tenant have in excess of $[___] on the Premises. Tenant shall provide Landlord with Tenant's daily cash transfer schedule and procedures and shall update such information to Landlord within twenty-four (24) hours of any changes to Tenant's cash transfer schedule and procedures."

<u>Payment of Rent</u>

Landlords should require tenants to pay rent, additional rent, and any other amounts due the landlord in the form of a check or wire transfer. Although marijuana tenants can only accept cash and sometimes would prefer to pay their expenses in cash, landlords will want to protect themselves from being subject to suspicious activity reports (SARs), which financial institutions are required to issue on any cash deposits greater than $10,000 or upon their discretion.

<u>Lease Example</u>

"Tenant shall pay all Rent, Additional Rent and any other amounts due to Landlord by check or wire transfer on the date set forth in this Lease. Unless otherwise agreed by Landlord, Tenant shall not be permitted to pay Rent, Additional Rent or any other amounts due Landlord in cash."

<u>Utilities</u>

Landlords may require a tenant to pay for excessive utility consumption and provide additional security in case a tenant vacates the premises without paying outstanding utility charges.

<u>Lease Example:</u>

"Any excessive consumption of water or electricity shall be at Tenant's sole cost and expense. No utilities user sharing the meter for electricity or water, as the case may be, shall be obligated to pay a disproportionate share of utilities. If Landlord determines that the only reasonable means for proper allocation of electricity/gas/water usage costs is the installation of a separate meter, Tenant shall pay the expense of the meter and its installation within five business days of the date upon which Landlord informs Tenant of its election to install a separate meter."

Inspection of Premises

Generally, access to areas containing marijuana products are highly restricted by state statutes. Landlords are typically not permitted to access certain areas without the applicable regulatory body's approval. Tenants should be required to give landlords access to the premises to the extent allowed by law and to assist landlords in receiving governmental approval for entry into any restricted spaces. Landlords should consider including a lease provision requiring the tenant to accompany the landlord during any inspections of the premises and to pay any costs associated with such inspections.

Lease Examples:

> *"If approval from the [insert relevant state and local regulators] or any other governmental authorities is necessary in order for Landlord or any mortgagee to inspect the Premises, Tenant shall use its best efforts to support obtaining such approvals for inspection, time being of the essence. If Landlord's access to certain space in the Premises is conditioned on Landlord being accompanied by a member of Tenant's management team, Tenant shall provide such access to the Premises as soon as reasonably possible, after Landlord request."*

> *"Landlord shall have the right, at any time any portion of the Premises is occupied by Tenant's principals, agents, or contractors, including at times when the Premises is not open for business to the public, to enter the Premises for the purposes of ensuring compliance with the covenants, warranties, and representations of Tenant under this Lease. In accordance with state licensing rules, Landlord must be accompanied by authorized Tenant personnel while inspecting limited access areas. Landlord may photograph or video-record in any medium the activities of Tenant, subject to privacy restrictions under HIPAA and state laws and so long as such visual records are not provided to anyone with an interest in possessing Tenant's trade secrets (other than government entities)."*

Indemnification

The indemnification section should cover specific issues that may arise from marijuana retail sale activities. Tenants should indemnify the landlord from and against any expenses related to any criminal enforcement or asset forfeiture (as permitted under the Controlled Substances Act), including reimbursement of attorney's fees and expenses related to any investigation regardless of whether a claim is brought. Landlords may also want to include provisions protecting themselves from property damage caused by robberies, break-ins, and burglaries.

Lease Example:

> *"Except to the extent caused by or resulting from Landlord's gross negligence or willful misconduct, Tenant shall save Landlord harmless, and will exonerate and indemnify and defend Landlord from and against any and all civil, criminal, or other claims, liabilities, or penalties, including attorney's fees, asserted by or on behalf of any person, firm, or public or governmental authority on account of or based upon Tenant's use of the Premises or any injury to a person, or loss of or damage to property, sustained or occurring within the Premises."*

Signage/Marketing

Many state enabling statutes heavily regulate the way marijuana products may be marketed and displayed. Landlords should require tenants to not only abide by state laws, but to also show proof that any proposed signage meets the appropriate state standards and regulations.

Lease Example:

> *"At all times during this Lease, Tenant shall comply with all applicable statutes and regulations involving [insert facility type] advertising, signage and marketing of the [insert facility type] business."*

Odors

Marijuana products may cause odors that migrate to other tenant spaces or off site. Tenants should have the duty to mitigate odors, which may include installing additional ventilation systems. This may not be a concern for every landlord depending on the building, proposed use, or neighboring tenants.

Lease Example:

> *"Tenant shall undertake reasonable and diligent steps to mitigate any odor emanating from marijuana located on the Premises."*

Tenant Improvements/Build-Out

The layout and buildout of marijuana facilities is often controlled by certain rules specific to the intended uses. Landlords should require tenants to obtain assurances or approvals of the design of the premises prior to commencing any construction. A lease should include a provision that relieves landlords of the duty to reimburse tenants for the cost of any improvements that are unique to marijuana operations and do not have any value to subsequent tenants. Landlords may also want to include language in the lease requiring a tenant to remove any improvements the landlord wants removed at the tenant's expense.

Lease Examples

> *"The parties acknowledge that the Premises are not currently fit for the permitted use and that the alterations listed in Attachment A will have to be construed to render the Premises fit and that:*
> *a. Tenant shall, at its sole expense, but with the good faith and reasonable cooperation of Landlord, secure all licenses, permits, and other approvals required to make such alterations;*
> *b. Tenant shall not be entitled to reimbursement from Landlord for making any alterations or improvements that are unique to the operation of a Cannabis business and provide no residual value to a subsequent tenant; and*
> *c. Tenant shall remove, at its sole expense, any and all alterations that Landlord designates for removal at the end of the Lease term."*
>
> *"Tenant's covenant to comply with all applicable Mandates shall apply equally to dismantling Tenant's operations at the end of the term and surrender of the Premises."*
>
> *"Tenant hereby covenants to dispose, according to Mandates, all unused inventory, refuse, and scrap materials and thereafter to clean to commercially acceptable standards (including sterilization of impermeable surfaces, wall to wall and ceiling to floor) all floors, walls, immovable fixtures, and air ducts serving the Premises."*

Events of Default

It should be a default if the tenant loses its marijuana permit or if any action is brought against the tenant for its activities. Landlords should specify which events terminate the lease. Early termination events may include federal criminal prosecution, enforcement actions, administrative proceedings, changes in enforcement priorities, property seizures, "nuisance" claims, bank foreclosures, or actions by cotenants. A landlord should also consider including a "Force Majeure" clause in case local authorities change local zoning, permitting, or licensing laws requiring a change to the rental agreement.

Lease Example:

> *"…Tenant's failure to maintain the [insert facility type] license in good standing with the applicable governmental authorities,"*
>
> *"…the initiation of any Federal enforcement investigation or action involving Tenant, Tenant's affiliates or Tenant's use of the Premises as a result of operating as a marijuana [insert facility type],"*

End of the Lease Term

Landlords should require a tenant to turn over the premises in a condition that will not subject the landlord to any liability relating to the activities performed on the premises.

Lease Example:

> *"Tenant shall remove, coordinate, and/or destroy, as permitted and directed by the applicable governmental authorities, all medical marijuana products remaining in the Premises upon expiration or earlier termination of this Lease."*

<u>Duty to Report</u>

Landlords should require the tenant to report any issues that arise on the premises or relate to the tenant's business or use of the premises. Landlords should ensure that the tenant involves appropriate authorities as necessary.

<u>Lease Example:</u>

> *"Tenant shall be required to report to Landlord within twenty-four (24) hours, including providing copies of any written notices, of any complaints received by Tenant, including but not limited to, patients, employees, agents, or owners, loitering, or using, smoking, vaping, dabbing, or consuming, in any form or fashion, any THC and/or CBD marijuana product in the Premises or Building, on the Property or on any adjacent properties. If Tenant receives any notices from the [insert relevant state and local regulators] or any other governmental authorities, regarding Tenant's [insert facility type] license or use of the Premises as a [insert facility type], Tenant shall submit such notices to Landlord within twenty-four (24) hours."*

<u>Definition of 'Laws'</u>

Many lease forms define 'laws' very broadly and prohibit activities which are 'illegal'. In a marijuana lease, any reference to 'laws' (or any reference to crime, rules, regulation, etc.) needs to be re-defined to pertain only to state laws (which permit marijuana use) and exclude federal law (where such use remains illegal). Leases should be crafted to require tenant compliance with all federal laws not involving the growth, storage, and sale of marijuana.

<u>Lease Example:</u>

> *Tenant's obligation hereunder shall include (i) all state and local laws and regulations from any governmental authority with jurisdiction over Tenant's use, including but not limited to [relevant state law and regulations] and local zoning ordinances; and (ii) all federal laws to the extent those laws are not inconsistent with state and local laws allowing Tenant to use the Premises for the specified permitted uses. The covenant to comply encompasses all applicable laws that become effective before and during the Lease term, as may be extended (collectively, the "Mandates"), regardless of the cost of such compliance. Tenant's inability to comply with the Mandates shall be grounds for termination of this Lease.*

OTHER AREAS OF CONCERN

<u>Insurance</u>

Insurance policies for marijuana tenants can be very expensive and typically contain many carve-outs regarding what is actually covered. Landlords will want to require tenants to obtain a robust insurance policy. However, landlords should be sensitive to what types of polices and coverages tenants can actually obtain.

<u>Security</u>

Landlords should be aware of the additional security concerns that come with leasing to marijuana tenants. Landlords should consider either requiring tenants to pay for additional security systems for the premises (which may include the hiring of a security guard) or building-in such costs to the lease. With regard to security guards, landlords should ensure a tenant hires an insured and reputable security company, or possibly require the hiring of off-duty policemen. Landlords also may want to specify whether security guards are permitted to be armed. (Note: This may be subject to state law specifics).

<u>Limitation of Liability</u>

Landlords will not want to limit their recovery for any breach of the lease or damages from the tenant's activities to exclude recovery from any partner, shareholder, member, trustee, or beneficiary of the tenant. Landlords should consider lease guaranties.

Landlord Reservations

Landlords should reserve the right to terminate the lease upon changes in laws related to the tenant's activities**,** including changes to applicable local, state, and federal laws, or upon revised official guidance concerning enforcement priorities from the Department of Justice (rescission of the Cole Memorandum).

Governing Law

Both landlords and tenants need to confirm applicability of laws governing the location of the marijuana activity and that counsel knowledgeable about the specific local requirements (such as zoning regulations) has reviewed the lease.

Waiver of Defense

Both landlords and tenants should waive any defense based on violation of federal laws and should stipulate that federal illegality based on the presence of marijuana is not a valid defense to a claim arising under the lease. Many states that allow marijuana cultivation require this term to be included in the lease, thus negating any federal "innocent owner defense" for a landlord.

Warranty of Suitability

Landlords may want to remove warranties that the premises are suitable for a tenant's proposed use, since this may require significant alterations to the premises, such as building code and zoning alterations and inspections. Tenants should be responsible for all necessary permits, licenses, and approvals.

Environmental Concerns

Both landlords and tenants should agree upon proper procedures for the disposal and storage of herbicides, pesticides, and fertilizers in addition to light and water use.

Friday, March 1, 2019
10:30 — 11:30 am

Concurrent Session B

Opportunity Zones for Real Estate Investment: Miracle or Mirage?

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Opportunity Zones for Real Estate Investment:
Miracle or Mirage?

This program reviews the Federal Opportunity Zone program enacted in December, 2017, regulations and other developments issued up to January 14, 2019 and state level programs which may be suitable for use with the Federal Opportunity Zone program.

A. Overview of Federal Program

I. Implementation of the Federal Opportunity Zone Program (Internal Revenue Code (IRC) Sections 1400Z-1 and 1400Z-2)
  a. Purpose: To provide significant tax incentives for investment in qualified opportunity zones (QOZ).
  b. Designation of QOZ by US Treasury

II. Benefits of Federal OZ Program/QOZ Incentives
  a. Temporary deferral of capital gain
  b. Basis step up
  c. Permanent exclusion of appreciation in value

III. Formation and compliance of a Qualified Opportunity Fund (QO Fund)
  a. Eligible entities
  b. Asset test at QO Fund level
  c. Self-certification

IV. Types of investments in an QOZ
  a. Real estate development and rehabilitation
  b. New business
  c. Expansion of business

V. Types of OZ Property
  a. Interest in QOZ via stock in corporation or equity interest in domestic partnership (including LLC)
  b. QOZ Business Property – tangible property purchased after December 31, 2017; original use or substantial improvement over 30 months; active trade or business operating in QO Zone; acquire from unrelated party.

VI. Rules for a QOZ Business – substantially all test; gross income test; use within OZ; cap on nonqualified financial property; no “sin uses”.

VII. Mixed use investment

VIII. Civil penalties for noncompliance by QO Fund with 90% test

B. Federal Regulatory Updates

I. Initial IRS Regulations issued on October 19, 2018
  a. Taxpayers may rely on proposed regulations until final regulations are published.
  b. Proposed regulations include guidance regarding real estate investments in OZs.
  c. The regulations confirm, among other things, that:
    i. “Substantial improvement” standard is based only on building cost.
    ii. “Substantially all” asset test for a QOZ Business is at least 70%.
    iii. 31 month safe harbor is available, permitting QOZ Business to hold cash for substantial improvements to real property or other tangible property.
    iv. Only equity (not debt) can be used to fund investments in QO Funds.
    v. Reinvestment of previously invested deferred gain is permitted. (Awaiting regulations on definition of “reasonable period” in which to re-invest.)
    vi. Investments in a QO Fund can be made by a pass-through entity that has a capital gain or by investors in that pass-through entity.
    vii. A QO Fund investment made in 2019 or later and held for 10 years qualifies for post-acquisition gain exclusion and continues to qualify until sold, even after expiration of the OZ designation on December 31, 2028.
  d. The regulations do not address, among other things:
    i. The application of the “active conduct of a business” test

ii. Tax consequences with respect to gains that a QO Fund reinvests.
iii. Whether a vacant or under occupied building can qualify for original use in an QOZ without satisfying the “substantial improvement” requirement.
iv. Certain issues with respect to the original use test.

II. Revenue Ruling 18-29 - Indicates that residential rental property is permissible “active trade or business” for OZs.
III. Status of additional regulations: IRS failed to meet its announced schedule to issue more regulations before the close of 2018.
IV. December 12, 2018 Executive Order increases support for OZs.
V. December 20, 2018 issuance by Joint Committee on Taxation raises question as to whether reporting will be required beyond self-certification.

C. Non-Federal Piggyback Opportunities

I. State Opportunity Zone Programs

Inevitable that states will adopt such programs, as they have done with historic tax credit programs and new markets tax credit programs

a. South Carolina legislation pending
b. Proposed Ohio legislation, H.B. No. 727 from 2018, not yet re-introduced in 2019.
    1. Investment credit as to Ohio QO Fund, but nonrefundable, no carryforward period, applies only to taxable year of investment, taxpayer must invest at least $250,000.
c. States need to decide whether to conform to the federal tax code for state tax purposes or whether to decouple from the federal tax code

II. Property tax abatement programs may be candidates for tweaking to enhance investment in OZs.
III. Tax Increment Financing programs may be layered with OZ benefits, to fund infrastructure improvements within an OZ.
IV. Numerous other incentives programs can be paired with OZ benefits

Opportunity Zones for Real Estate Investment: Miracle or Mirage?

A. Overview of Federal Program

I. Implementation of the Federal Opportunity Zone Program
   a. Internal Revenue Code (IRC) Sections 1400Z-1 and 1400Z-2
      i. Enactment: December 22, 2017, as part of Tax Cuts and Jobs Act of 2017.
      ii. Origin: Based on analysis of Federal Reserve data, Economic Innovation Group (EIG), a bipartisan research and advocacy organization, estimated that U.S. Taxpayers held $6.1 trillion in unrealized capital gains at the end of 2017. https://eig.org/news/joint-economic-hearing-promise-opportunity-zones
         1. EIG helped plan the initial legislation that formed the basis for the QO Zone Incentives.
      iii. Purpose: To provide significant tax incentives for taxpayers to reinvest unrealized capital gains in certain property and businesses located or operating in low-income census tracts that the Department of Treasury designates as qualified opportunity zones (QOZ).
   b. Designation of QOZ
      i. Treasury has designated QOZs in all 50 States, the District of Columbia, and five U.S. possessions and the map is final.
      ii. In Ohio, Treasury designated 320 tracts in 73 counties across the state as QO Zones.
      iii. In Kentucky, Treasury designated 144 low-income census tracts in 84 counties across the state as QO Zones.
      iv. In Indiana, Treasury designated 156 tracts in 58 counties covering all or portions of 83 cities and towns throughout the state as QO Zones.
      v. In Michigan, Treasury designated 288 census tracts in 81 counties across the state as QO Zones.
      vi. In Pennsylvania, Treasury designated 300 census tracts in 45 counties across the state as QO Zones.
      vii. An interactive map that permits the user to zoom in on specific addresses, census tracts, and opportunity zones across the country can be found at the following link: https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
      viii. See Exhibit A for maps for Ohio, Kentucky, Indiana, Michigan and Pennsylvania.

II. Benefits of Federal OZ Program/QOZ Incentives
   a. Temporary Deferral
      i. Taxpayer can elect under IRC Section 1400Z-2(a)(1)(A) to temporarily defer capital gain from the sale or transfer to an unrelated party of any property that the taxpayer owns, so long as the taxpayer reinvests the deferred amount in a qualified opportunity fund (QO Fund).

ii. Any asset that generates capital gain when sold qualifies for a deferral, including, for example, publicly traded stock, real estate, or a privately-owned business.
iii. Taxpayer must reinvest the deferred amount within the 180-day period beginning on the date of the sale or transfer of the property generating the gain.
iv. Gain deferral is temporary because the taxpayer must recognize the income in the tax year the investment is sold or the tax year that includes December 31, 2026, whichever is earlier.
v. A taxpayer can make an election to defer gain when it files a federal income tax return in the year gain would have been realized. It is anticipated that taxpayers will use Form 8949 to elect to defer gain by attaching it to their federal income tax return in the year the gain would have been recognized if an election was not made.

b. Basis Step Up
   i. Where a taxpayer has elected temporary gain deferral, IRC Section 1400Z-2(b)(2)(B) provides a tiered "step-up" in the taxpayer's basis in the gain it reinvests in the QO Fund, depending on how long the taxpayer holds the investment.
   ii. Absent this statutory "step-up," the taxpayer's initial basis in the reinvested gain is zero.
   iii. "Step-Up" Holding Period
      1. If the taxpayer holds the investment for at least 5 years, the taxpayer's basis in the investment is increased by an amount that is equal to 10% of the amount of capital gain that the taxpayer elected to defer.
      2. If the taxpayer holds the investment for 7 years, the taxpayer's basis is increased by an additional 5% of the deferred gain.
      3. Accordingly, 15% of the deferred gain will avoid taxation altogether if the investment in the QO Fund is held for 7 years and on December 31, 2026, the taxpayer will recognize 85% of the deferred gain.
   iv. Because the temporary gain deferral period ends no later than the tax year including December 31, 2026, the taxpayer will need to reinvest capital gain in a QO Fund and elect deferral treatment by December 31, 2019 to permit the taxpayer to hold the investment for 7 years and receive the full benefit of the basis step-up provision.

c. Permanent Exclusion
   i. Taxpayer can elect under IRC Section 1400Z-2(a)(1)(C) for an additional basis "step-up" that permanently excludes capital gain on the sale or transfer of an investment that the taxpayer holds for at least 10 years.
   ii. Where the taxpayer makes an election and holds the investment for at least 10 years, the taxpayer's basis in the investment is equal to the fair market value of the investment on the date the investment is sold – taxpayer is able to dispose of the property tax-free.

III. Formation and Compliance of a Qualified Opportunity Fund

a. Any investment vehicle organized as either a partnership (including an LLC treated as a partnership for tax purposes) or corporation that was formed for the purpose of investing in qualified opportunity zone property (QOZ Property).
b. At least 90% of the QO Fund's assets must consist of QOZ Property. This test is applied by measuring the assets as shown on the applicable financial statement used by such entity, with an alternative approach available if the entity does not have an applicable financial statement. (The same test applies to the 70% test at the QOZ Business level, as discussed below at Section B.I.c.iv.)
c. A taxpayer can self-certify to become a QO Fund using Form 8996 and attaching it to the tax return of the QO Fund entity.
d. Taxpayers do not need pre-approval from the IRS to establish a QO Fund.

IV. Types of Investments in an Opportunity Zone
a. Real estate development and rehabilitation
b. New business
c. Expansion of business

V. Types of Qualified Opportunity Zone Property
a. QOZ Stock - any stock in a domestic corporation if:
   i. The QO Fund acquired the stock after December 31, 2017 at its original issue for cash;
   ii. At the time of issue, the corporation was a qualified opportunity zone business (QOZ Business) or was organized to be a QOZ Business; and
   iii. During substantially all of the time the QO Fund held the QOZ Stock, the corporation qualified as a QOZ Business.
b. QOZ Interest - any capital or profits interest in a domestic partnership (including an LLC treated as a partnership for federal tax purposes) if:
   i. The QO Fund acquired the interest after December 31, 2017 in exchange for cash;
   ii. At the time the QO Fund acquired the interest in the partnership, the partnership was or was organized to be a QOZ Business; and
   iii. During substantially all of the time the QO Fund held the interest, the partnership qualified as a QOZ Business.
c. QOZ Business Property
   i. Tangible property that a QO Fund or QOZ Business purchased after December 31, 2017 and that is used by the QO Fund/QOZ Business in a trade or business operating in a QO Zone for substantially all of the time that the QO Fund/QOZ Business owns the property.
   ii. The original use of the property in the QO Zone must begin with the QO Fund or QOZ Business, or the QO Fund/QOZ Business must *substantially improve* the property.
   iii. Property will be treated as "substantially improved" if the basis of the QO Fund or QOZ Business in the property increases over a 30-month period beginning at acquisition by an amount that exceeds its initial basis (i.e., the purchase price) in the property.
      1. The improvement expenditures of the QO Fund or QOZ Business in the property over the 30-month period must exceed the original acquisition price.

2. Any portion of the acquisition price attributed to the value of land is excluded from the amount necessary to substantially improve a building located on the land.

iv. To qualify as QOZ Business Property, the QO Fund or QOZ Business can acquire the property only from an unrelated party.

v. Property that a QO Fund or QOZ Business purchases in a transaction involving certain prohibited relationships such as individuals from the same family, entities related through common ownership or control, or entities from the same controlled group, may not be considered QOZ Business Property.

d. Limitation

i. QOZ Property cannot include an interest in another QO Fund.

VI. Rules for a Qualified Opportunity Zone Business

a. The activity must be a trade or business in which *substantially all* of the tangible property owned or leased by the taxpayer is QOZ Business Property.

b. At least 50% of the total gross income of the taxpayer must be from the active conduct of such trade or business activity within the OZ.

c. The taxpayer must use a substantial portion of its intangible property in the active conduct of such trade or business activity within the OZ.

d. Less than 5% of the average aggregate unadjusted basis of the property of the entity may be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, or annuities).

e. The trade or business activity must <u>not</u> constitute a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

VII. Mixed Use Investment

a. The taxpayer is permitted to invest funds in the QO Fund of which only a portion of the investment consists of gain for which the taxpayer made a deferral and exclusion election under IRC Section 1400Z-2.

b. The taxpayer will be entitled to OZ tax incentives on only the portion of the investment for which the taxpayer made the election (i.e., the reinvested capital gain).

c. If the taxpayer makes a "mixed fund" investment, the taxpayer is treated as having made two separate investments in the QO Fund – one investment to which the deferral election was made, and the other investment consisting of the remaining amount. The OZ tax incentives apply only to the former investment and not the latter.

VIII. Civil Penalties for Noncompliance

a. If a QO Fund fails to meet the requirement that it hold at least 90% of its assets in QOZ Property, the QO Fund must pay a penalty for each month that the Fund is non-compliant. The penalty is based on the difference between the 90% requirement and the actual percentage of the QO Fund's assets in QOZ Property and the penalty rate is the underpayment rate under IRC Section 6621(a)(2), which is currently 6%.

b. No penalty will be imposed if there is reasonable cause for the QO Fund's failure to meet the threshold.

B. Federal Regulatory Updates

I. Initial IRS Regulations

a. Issued on October 19, 2018

i. The regulations are proposed, not final

ii. A public hearing scheduled for January 10, 2019 was cancelled and rescheduled to the date that that is at least two weeks after the next hearing notice is issued.

iii. These regulations may be relied upon by taxpayers until final regulations are published.

b. The regulations provide sufficient guidance to permit real estate investments in OZs to move forward.

c. The regulations confirm, among other things, that:

i. The "substantial improvement" standard is based only on building cost and excludes land cost.

1. The "substantial improvement" standard for investments made in QOZ Business Property is based only on building cost and excludes land cost. The QO Fund (or the LLC, partnership or corporation in which the QO Fund owns an interest) can be used to purchase the land, but only the cost of the building (not the cost of the land) is taken into account to determine if the substantial improvement standard is met.

ii. A QO Fund can be an LLC treated as a partnership for tax purposes.

1. An entity organized as an LLC under state law that is treated as a partnership for federal income tax purposes (along with a LLC, partnership and corporation under state law) is eligible to be a QO Fund. The QO Fund can invest by having an equity interest in a separate LLC, partnership or corporation.

iii. A QO Fund may identify the first month in the initial taxable year in which the entity wants to be a QO Fund, which does not have to be the date the QO Fund was created.

1. Investments in a QO Fund are eligible for the tax benefits only if the QO Fund has self-certified through filing IRS Form 8996 that is effective at the time that QO Fund investment is made.

2. The QO Fund may select the month that self-certification is first effective. The first QO Fund month is the commencement of the six-month period in which the QO Fund must meet the 90% test. (As noted in Part A of this paper, at least 90% of the QO Fund's assets must consist of QOZ Property.)

3. Absent additional guidance, if a QO Fund selects as its first month relating to the 90% test a month during the second half of a calendar year, then the QO Fund needs to meet the 90% test by December 31.

iv. The threshold for purposes of determining whether "substantially all" of the tangible property owned or leased by a QOZ Business is QOZ Business Property is at least 70%.

1. "Substantially all" of a QOZ Business's tangible property must be QOZ Property, but the OZ statutes did not provide a threshold for determining compliance with that requirement.
2. The regulations provide that, with respect to this requirement, "substantially all" means that at least 70% of all tangible property owned or leased by a QOZ Business must be QOZ Property. (See above at Section A.V.c for discussion of criteria for QOZ Property.)
3. The 70% substantially all test, for a QOZ Business in which the QO Fund holds an interest, is applied by measuring the assets as shown on the applicable financial statement used by such entity, with an alternative approach available if the entity does not have an applicable financial statement. (The same measurement method applies to the 90% test.)

v. A 31 month safe harbor is available, permitting a QOZ Business to hold cash for substantial improvements to real property or other tangible property.

1. Notwithstanding the requirement that capital must be deployed within six months after investment in a QO Fund, if a QO Fund places funds in a separate LLC, partnership or corporation that engages in a QOZ Business by acquiring, constructing or rehabilitating real property in an OZ, the QOZ Business has a working capital safe harbor of up to 31 months for deploying the funds, subject to the conditions set forth in item 3 below.
2. The safe harbor is available through a second-tier entity; the QO Fund itself still has a very short period to deploy the cash, but it can satisfy this requirement by investing in a second-tier entity and the cash investments into the QO Fund are transferred to the second-tier entity.
3. The safe harbor is available if there is (1) a written plan that identifies the cash as held for property development, (2) a written schedule consistent with ordinary business operations showing how the cash will be spent over the construction period (not to exceed 31 months) and (3) the business substantially complies with the schedule.
4. The 31-month safe harbor coincides with the permitted 30 month period available to substantially improve certain purchased tangible property.
5. Apart from the cash reserve safe harbor available for property development, the cash held by the QO Fund and the LLC, partnership or corporation in which the QO Fund holds an equity interest needs to be less than 5% of the aggregate tax basis of the assets held by each such entities.

vi. Only capital gains are eligible for deferral through investment in a QO Fund.

1. Only capital gains (long term and short term) invested in a QO Fund are eligible for deferral.
2. Depreciation recapture amounts, which are taxed as ordinary income instead of being included in the taxpayer's computation of capital gain, are ineligible.
3. Note that only the capital gain portion of a property sale or exchange is eligible for a QO Fund investment. If the taxpayer invests all of the proceeds into the QO Fund, less than all of the investment is eligible for the federal income tax benefits, thus diluting some of the future tax benefit available.

vii. Only equity (not debt) can be used to fund investments in QO Funds.

1. Qualifying investments in the QO Fund must be equity, including preferred shares and LLC interests with special allocations.
2. The regulations confirm that convertible debt is not an eligible investment in a QO Fund.

viii. Borrowings by a QO Fund (or lower-tier entity pass-through entities) is not a substitute for investment of cash that constitutes capital gains. However, investors in a QO Fund can borrow against their respective QO Fund equity interests as collateral and use the borrowed funds as the QO Fund investment.

ix. Reinvestment of previously invested deferred gain is permitted.

1. The regulations provide that if an investor sells or exchanges an interest in a QO Fund (acquired in connection with a gain deferral election) prior to December 31, 2026, the investor must include the previously deferred gain in income in the taxable year of that sale or exchange.
2. However, the regulations also indicate that, even after the sale of a QO Fund interest, the favorable gain treatment may be retained as long as the investor disposed of the entire initial investment and the sale proceeds are reinvested in the same or another QO Fund within 180 days of the inclusion-triggering disposition.
3. The OZ statutes grant a QO Fund a "reasonable period" in which to re-invest the return of capital from investments in a second-tier entity or the proceeds from a sale or other disposition of QOZ Business Property, and authorize regulations to provide guidance on what constitutes a "reasonable period" for re-investment, but the current regulations do not provide that guidance.
4. The regulations also provide identification rules for QO Fund investments that are fungible and indistinguishable interests (e.g., equivalent shares of stock or partnership interests with identical rights) that are made and sold over a period of time.

x. A taxpayer is allowed to make multiple elections, within 180 days, with respect to various parts of the gain from a single sale or exchange of property.

1. The OZ statute prohibits an election with respect to a sale or exchange if there is a previous election with respect to that sale or exchange in effect.
2. The regulations clarify that this provision is intended to prevent a taxpayer from making multiple elections with respect to the same gain but does not prohibit a taxpayer from making multiple elections with respect to various portions of gain from a sale or exchange.

xi. Investments in a QO Fund can be made by a partnership or other pass-through entity that has a capital gain or, if the pass-through entity does not make such investment, then the pass-through owners can make the investment.
   1. Under the regulations, with respect to eligible capital gains from a sale or exchange of an asset by the pass-through entity, either the pass-through entity can elect to defer all or part of the gain or, to the extent that the pass-through entity does not so elect, the pass-through owners to whom the entity allocates such capital gain may elect to defer all or part of the gain.
   2. If the pass-through entity makes the election to defer, the 180-day period for the pass-through entity begins on the date that the pass-through entity sells or exchanges the asset and realizes the gain.
   3. If the pass-through entity elects to use the QO Fund for only part of the gain from a property sale, each pass-through owner can elect to make a QO Fund investment for the balance of the eligible gain.
   4. If the pass-through entity decides not to make a QO Fund investment, the pass-through owner's 180-day period to invest does not begin until the last day of the pass-through entity's tax year. However, as an alternative, a pass-through owner may elect to treat the pass-through owner's 180-day period as being the same as the pass-through entity's 180-day period (thus, it would begin on the date of the realization event).

xii. A QO Fund investment made in 2019 or later and held for 10 years qualifies for post-acquisition gain exclusion and continues to qualify until sold, even after the expiration of the OZ designation on December 31, 2028.
   1. Under the regulations, the latest date on which an investor can make an investment of deferred gain in a QO Fund to which the basis step-up election, applicable after a 10-year hold, applies is June 28, 2027 (180 days after December 31, 2026). Any additional investment made into that QO Fund after June 28, 2027 (with respect to which a deferral election may not be in effect) is not eligible for the basis step-up upon sale.
   2. However, the regulations provide that, as to a QO Fund interest purchased before June 28, 2027, the investor may continue to take advantage of the increase in basis to fair market value on the sale when the interest is actually sold, but the step up in basis must

occur no later than December 31, 2047. The IRS is considering whether this step up in basis may occur at the end of 2047 without the necessity of an actual sale.

d. The regulations do not address, among other things:

   i. The application of the "active conduct of a business" test to real estate operations.

      1. 50% of a QOZ Business's gross income must be from the "active conduct of" a business in an OZ.

      2. The regulations reserve on the definition of the "active conduct" of a business, so questions regarding what "active" means are not resolved. This may mean that "triple net leasing" of real estate by a QOZ Business may not qualify as active.

   ii. What constitutes "reasonable cause" for not meeting the 90% test.

      1. At least 90% of a QO Fund's assets must be QOZ Property. QOZ Property includes qualified QOZ stock, QOZ partnership interests and QOZ Business Property.

      2. The statute provides that the 90% test is applied by determining the average of the percentage of QOZ Property held in the QO Fund as measured on the last day of the first six-month period of the taxable year of the QO Fund, and the last day of the taxable year of the fund. If a QO Fund fails to meet the 90% test and does not establish reasonable cause, the QO Fund is required to pay a monthly penalty of the excess of the amount equal to 90% of its aggregate assets, over the aggregate amount of QOZ Property held by the QO Fund multiplied by the underpayment rate in the tax code.

      3. There is an exception from application of the penalty if the QO Fund can show that it had "reasonable cause" for failing the test, but the regulations provide no guidance on when or how this exception will apply.

   iii. What is a "reasonable period" for the reinvestment from a sale or other disposition.

      1. The statute authorizes the regulations to provide guidance on what constitutes a "reasonable period" for re-investment, but the regulations do not provide that guidance.

   iv. What are the tax consequences with respect to gains that a QO Fund reinvests.

      1. Are the gains deferred? Does the reinvestment by the QO Fund within a reasonable time period mean that the investors (if the QO Fund is a pass-through entity) or the QO Fund (if the QO Fund is a corporation) do not recognize any gain on the sale?

      2. The statute clearly contemplates re-investment, but is silent as to whether the re-investment is treated as a continuous investment such that no gain is recognized.

      3. The comments in the preamble to the regulations indicate that Treasury and the IRS understand the need for clarification, but that

they need to provide this clarity in the context of a "statutorily permissible possibility." In other words, it is not sufficient to regulate in a manner that is consistent with the intent of the statute if the regulation is counter to specific statutory language. So, in some cases, the "clarification" or fix to some of the issues in the statute may have to come from additional legislation.

v. Whether a vacant or under occupied building can qualify for original use in an QOZ without satisfying the "substantial improvement" requirement.

vi. Certain issues with respect to the original use test, including:

1. How does the original use test apply to the purchase of vacant land or a property where the building must be demolished? Land's original use cannot be first established with the QO Fund.

2. Whether a shell or mere foundation of a building without a certificate of occupancy can qualify as original use in a OZ.

vii. Whether a ground lease or land contribution by a related person does not taint a building constructed on such land.

II. Revenue Ruling 18-29

a. Along with the regulations, the IRS released Revenue Ruling 18-19, in which it uses a residential rental property as an example, seemingly addressing the question that some tax professionals raised as to whether residential rental property is considered a permissible "active trade or business" for OZs.

b. On a technical level, it is interesting that the Revenue Ruling addresses the situation in which the QO Fund owns residential rental property, but not the more common situation in which an operating company owned substantially by a QO Fund owns the residential rental property, but the example is helpful for both situations.

c. The Revenue Ruling goes on to discuss the substantial improvement test for real estate, saying that improvement costs added to basis in a 30-month period must be at least equal to the tax basis of the building only; land value is not counted and need not be increased.

III. Status of additional regulations. The IRS promised more regulations before the close of 2018, but that deadline was not met. Given the December 31, 2019 deadline for making an investment that could receive the full 15% reduction in deferred capital gains tax (after holding for seven years) and the increased interest in the development of QOZ Properties, many investors are actively seeking to take gains and identify potential real estate projects or QO Funds now. However, it is not clear when additional IRS guidance will be provided.

IV. Final Form 8996 and instructions for self-certification and annual reporting as to compliance with certain tests for QO Funds were issued in December, 2018.

a. The Form 8996 is now available and would be filed with the QO Fund income tax return to self-certify and then annually to confirm that the 90% test is met.

V. Executive Order Increases Support for OZs.

a. On December 12, 2018, President Trump signed an Executive Order creating a White House Opportunity and Revitalization Council of 13 federal agencies charged with developing policies and programs to support investment in OZs.

b. While the mandate to the new council is not limited to OZs, the Executive Order clearly is motivated by a desire to facilitate investments in OZs. On the other hand, it is not yet known whether any programs developed by the inter-agency council will be applied to all OZs or distressed areas, or will apply more selectively. The order includes time periods (of up to one year) for the issuance of recommended changes to support the development of these distressed areas.

c. Additional benefits may become available from this initiative, including potential federal support, in addition to the tax benefits of the OZ program, in the form of funding for infrastructure and crime reduction.

d. The Executive Order also directs the council to recommend policies that would streamline application processes and align certain program requirements to facilitate use of multiple programs to fund a project.

VI. Qualified Opportunity Fund Certification Process.

a. On December 20, 2018, the Joint Committee on Taxation issued its explanation of the 2017 Tax Act, including information with respect to the certification process for Qualified Opportunity Funds. This publication includes the statement, "The provision intends that the certification process for a qualified opportunity fund will be carried out in a manner similar to the process for allocating the new markets tax credit. The Secretary is granted the authority to administer this process."

b. This leaves open the possibility that a governmental pre-approval process may be required to accomplish certification, or that the Secretary will require more extensive reporting, beyond submitting some general reporting information.

C. Non-Federal Piggyback Opportunities

I. State Opportunity Zone Programs

   a. Inevitable growth

      i. 34 states have historic tax credit programs (Renee Kuhlman, National Trust for Historic Preservation, Preservation Leadership Forum, The State of State Historic Tax Credits (2017), https://forum.savingplaces.org/blogs/renee-kuhlman/2017/01/13/the-state-of-state-historic-tax-credits)

      ii. 12 states have new markets tax credit programs (New Markets Tax Credit Resource Center, Novogradac & Company LLP)

         1. Maine
         2. Ohio
         3. Kentucky
         4. Illinois
         5. Florida
         6. Alabama
         7. Mississippi
         8. Louisiana
         9. Arkansas
         10. Nebraska
         11. Utah
         12. Nevada

      iii. Popular issues for legislators and governors

         1. Assistance to the need/low-income areas
         2. Lower taxes
         3. Job creation

   b. Some legislation pending or imminently pending

      i. South Carolina

         1. H. 3186, sponsored by Rep. Marvin Pendarvis, introduced on December 18, 2018.
         2. Income tax credit equal to 25% of the total OZ investment costs, not to exceed $50,000.
         3. Taxpayer may claim credits only for year in which investment is made.
         4. Five-year carry forward.

   c. Proposed Ohio legislation

      i. Summary of legislation introduced in 2018 as H.B. No. 727

         1. Introduced on August 29, 2019 by then-House Speaker Pro Tempore Kirk Schuring.
         2. As of January 15, 2019, not yet re-introduced in the 133rd General Assembly.
         3. Credit equal to 10% of investment in an Ohio QO Fund, but …

            a) Credit is nonrefundable.
            b) No credit carryforward period.

c) Credit can be claimed only against the aggregate tax liability for the taxable year in which the investment is made.

d) Taxpayer must invest at least $250,000.

4. Investment need not be from a capital gain.

ii. Key limitations --Lack of refundability, lack of carryforward, and requirement that it be claimed (to the extent it can be claimed) for the taxable year in which the investment is made are significant restrictions that are particularly noteworthy in light of federal OZ considerations.

1. Ohio taxable income is based on federal taxable income, so when federal taxable income is deferred, the Ohio taxable income will be deferred to a year for which the Ohio OZ credit is unavailable for the investment to which it related.

2. For example, a taxpayer with $1M of capital gain that is invested in an Ohio QO Fund in 2019, and who has $500,000 of other income, may have an Ohio tax liability for 2019 of approximately $23,000. The nominal value of its Ohio OZ credit for 2019 would be $100,000, but it would be able to use only $23,000 of it. Most significantly, when 85% of the deferred income is recognized for 2026, the taxpayer will not be able to use any of the Ohio OZ credit generated from that $1M investment against the tax on that $850,000 of deferred income.

3. Simplest solution (other than refundability): a carryover of the Ohio OZ credit through the year the deferred gain is recognized (2026 under current law).

iii. Key open issues

1. Requires that 100% of the assets of the Ohio QOF must be QOZ Property. Federal requirement is 90%.

a) Any cash held directly would be disqualifying.

b) Any property held by the fund which was used in the zone by someone other than the fund, and not substantially improved by the fund, would be disqualifying.

c) Property held directly by the fund would qualify as qualified opportunity zone property only if "during substantially all of the QOF's holding period, substantially all of the use of the property was in a QOZ." Therefore, for example, one delivery truck, one tool, one cellphone, etc. that is used primarily outside of the zone would be disqualifying if owned by the fund.

2. How is the $250,000 threshold applied in the context of a pass-through entity? Is the pass-through entity the taxpayer, or must each member of the taxpayer be responsible for at least $250,000?

3. As drafted, a taxpayer must invest the entire $250,000 threshold in a single Ohio QO Fund.

a) Should a taxpayer be permitted to satisfy the investment requirement by investing in multiple OH QO Funds?

d. Conformity with federal tax code
   i. While some states are not yet proposing additional state-level benefits, such as South Carolina and Ohio, others need to decide whether to conform to the federal tax code for state tax purposes or whether to decouple from the federal tax code
   ii. Massachusetts
      1. Corporate income tax statutes generally adopt federal tax code changes as they occur.
      2. However, personal income tax changes conform to the federal tax code as of the year 2005.
      3. Therefore, corporate taxpayers investing in QO Funds will receive the same income tax benefits for Massachusetts income tax purposes as they will for federal income tax purposes (absent decoupling legislation), but Massachusetts would need to affirmatively pass conforming legislation before individual taxpayers could obtain the benefits.
   iii. Ohio
      1. Ohio adopts the federal tax code each year (ORC 5701.11).
      2. Absent decoupling legislation, both the deferral and exclusion of capital gains should flow through to Ohio taxpayers who invest in a QO Fund (although capital gains are not subject to CAT).
      3. Not aware of any proposed decoupling legislation.

II. Property Tax Abatement Programs
   a. Most states provide property tax abatement programs – either directly or indirectly – to incent investments in specific areas, to win competitive projects, or both
   b. Most property tax abatement programs are discretionary, with local authorities provided with significant decision-making authority
   c. OZ opportunities
      i. Provide enhanced abatements in opportunity zones
         1. Statutory enhancement
         2. Policy enhancement
      ii. Enact new property tax abatement programs to enhance the benefits of an OZ designation
      iii. Use existing discretion to approve property tax abatements more aggressively
      iv. Provide for flexibility regarding abatement assignments, changes in control, etc., particularly at the end of an OZ holding period

III. Tax Increment Financing Programs
   a. Many states provide tax increment financing (TIF) programs to incent investments and development in specific areas, to win competitive projects, or both
   b. TIF is discretionary, with local authorities provided with significant decision-making authority
   c. OZ opportunities

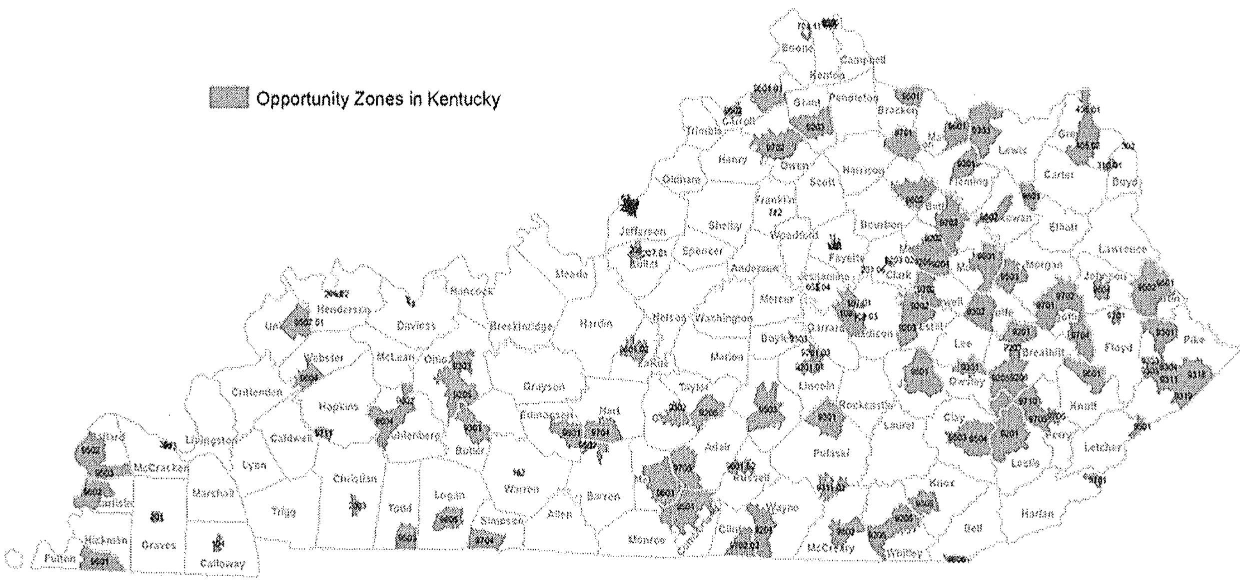
i. TIF could be used to help fund infrastructure improvements within an OZ, making the OZ potentially more attractive
   1. TIF can be layered with property tax abatements to maximize benefits
ii. Provide enhanced benefits in opportunity zones
   1. Statutory enhancement
   2. Policy enhancement
iii. Enact new TIF programs to enhance the benefits of an OZ designation
iv. Use existing discretion to approve TIF more aggressively

IV. Other Incentives Programs
   a. Numerous incentives programs can be paired with OZ benefits – grants, low-interest loans, job creation/retention tax credits, development authority ownership structures, workforce training
   b. E.g., On January 3, 2019, Maryland Governor Larry Hogan announced the creation of a task force that will hold regional summits throughout Maryland and develop a State Opportunity Plan to align state incentives programs, including a potential new OZ credit, with the state's OZs.
   c. Key considerations for policymakers and end users
      i. Assignability
      ii. Changes in control
      iii. Future changes in demographics of low-income census tracts
      iv. Refundability
      v. Carryforward periods
      vi. Certificated, sellable credits
      vii. Syndicated credits
      viii. Types of taxes against which credits can be claimed
      ix. Reporting requirements
      x. Capped vs. uncapped
      xi. If capped, competitive vs. first-come, first-served
      xii. Impact if OZ program is extended beyond 2026

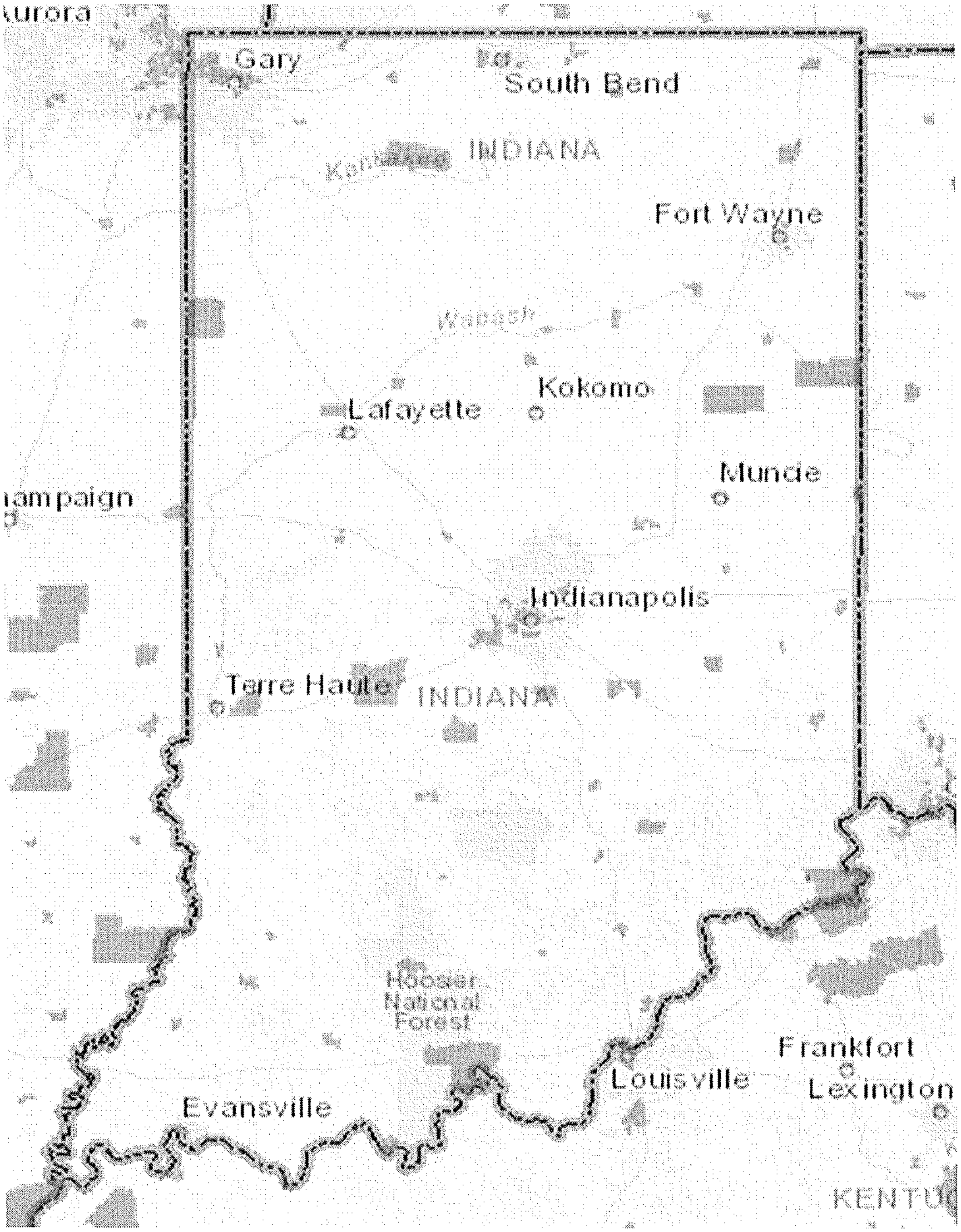
EXHIBIT A

QO Zones in Ohio

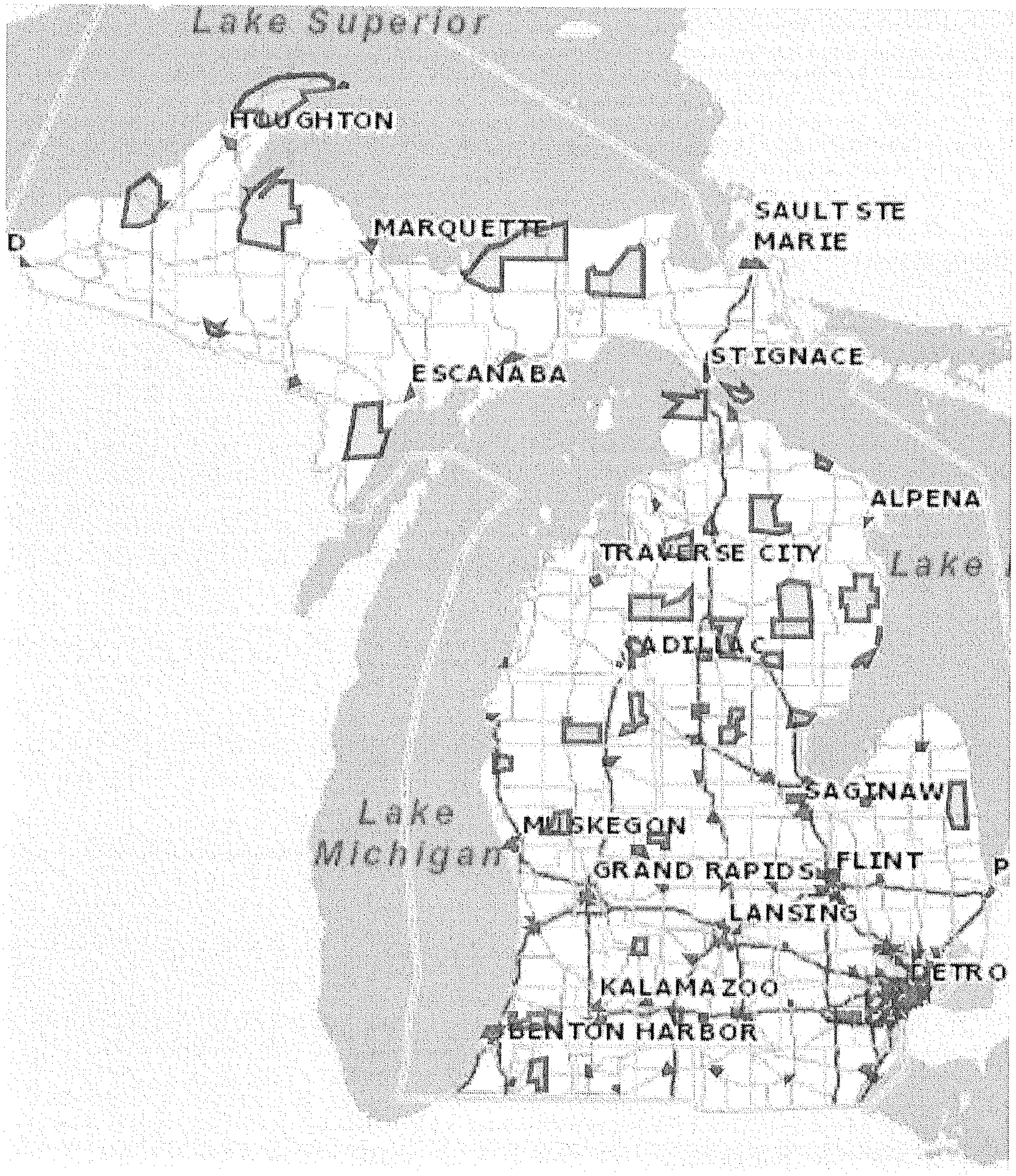
QO Zones in Kentucky



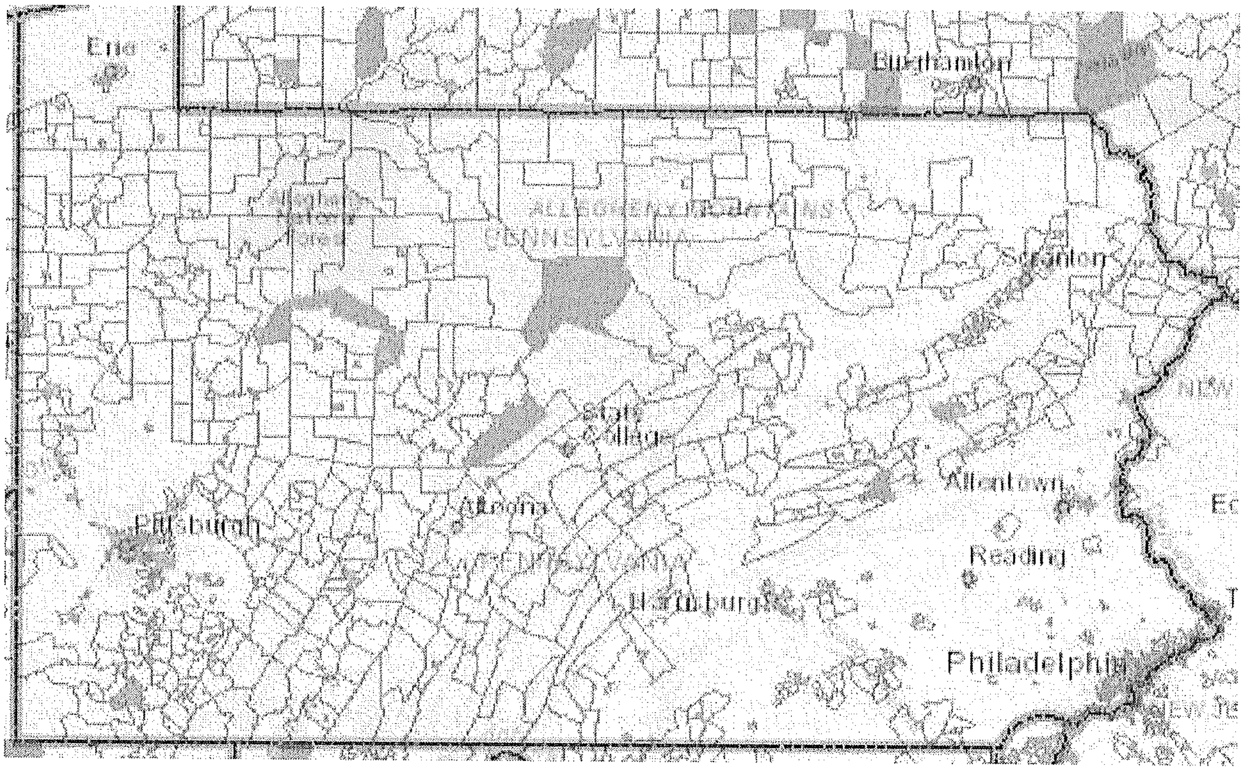
QO Zones in Indiana



QO Zones in Michigan



QO Zones in Pennsylvania



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Friday, March 1, 2019
11:45 am – 12:45 pm

Concurrent Session A

Show Me the Retail Money: Multi-Channel Retail Solutions to the Retail Leasing Challenge

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Columbus, OH

(A) The Internet Has Changed Everything.

As far as retail goes, it is clear that the internet has changed everything. Instead of needing five locations in a given market, the retailer now wants to be only in the one or two best locations and will infill the rest of the market through the internet. Some retailers have simply closed locations. Others have reformulated their prototype to a smaller size. This has left a glut of empty retail space.

Bulldozing is an obvious solution. But David Birdsall of Anchor 360 Property Partners says "It's not that there is too much retail. It's that there is too much obsolete retail." So "redevelopment" may be a better option.

Ten years ago, redevelopment meant creating a "lifestyle" center, whatever that is. Today, developers are more tuned in to what consumers want. A successful retail project must create an experience. As noted in the December 2018 Shopping Center Today article "Online Retailers are Going From Clicks to Bricks", successful retail projects look good on Instagram. Kendall Kadish, a real estate attorney (who is of the age where he understands social media and just happens to be my son), told me last year at this conference that a successful project is one where you want to post your visit on Instagram. In other words, the consumer needs a reason to visit instead of buying over the internet. Amenities like valet parking, community meeting space, classes and concierge services, and special events like farmer's markets, night at the movies and celebrity guests, are now common.

In addition to the experiential requirement, certain retail industries are internet resistant. Restaurants for example have become the new "anchor". And you can't get a haircut over the internet – service type retailers still need a physical location and will drive consumers to the center.

(B) Multi-Channel Retailing.

Multi-Channel Retailing is focusing on all of the ways a retailer can reach its customers – the internet, catalogue and physical location. Today's most successful retailers have figured out how to implement a seamless multi-channel sales program. They realize bricks and clicks are not exclusive propositions – rather they are complimentary. A recent ICSC Survey "The Halo Effect – How Bricks Impacts Clicks" found that opening one new physical store in a market results in an average of 37% increase in overall traffic to that retailer's website. In addition, physical locations allow shoppers the ability to experience the products they are buying and allows the retailer to gain more personal information on consumer preferences. The Survey suggests that a retailer must have its online and physical shopping options work in harmony to operate most effectively.

(C) Pop Up Leasing.

Some established retailers are faced with implementing an on line strategy that works. But for landlords with empty space, the opportunity is presented by emerging on-line retailers realizing that they need a physical location. Most on line retailers are not ready or even able to launch a wide spread expansion program to open physical locations in volume. Most retail leases involve long terms (10 years is fairly common) with significant upfront capital expenditures. So landlords must find new ways to get the on-line retailer started.

The most well publicized strategy is a "pop up". A pop up is just a trendy way to describe temporary leasing. But it is an effective tool for landlords and retailers alike. From the retailer's perspective, it creates an easy, fast, inexpensive, low risk way for the retailer to test its retail strategy, to build brand awareness and get their products physically in the hands of consumers. For landlords, it is an easy way to fill out vacant space while bringing in new concepts and driving traffic to the center. Pop ups create a buzz and excitement as new tenants emerge creating a reason to come back to the center time and again to visit the changing tenant mix. It helps create an experience for the consumer, differentiating the center form the plain vanilla center that has the same tenants as every other center. Joe Purifico, President and General Counsel of JBC & Associates noted in the November, 2018 edition of Shopping Centers Today that creating desirable tenant mixes and finding new tenants has been a challenge. He said "[landlords] need to incubate new tenants. This pop-up industry is the vehicle that is going to help them achieve that".

The traditional "pop-up" is just a short-term lease. It might be 30-60 days and may be more properly called a license agreement. It would typically be an as is delivery, gross rent deal with the rent pre-paid. Tenant pays for signage and to merchandise the store and supplies its own employees to man the store. Depending upon lease terms, it may not violate another tenant's exclusive if it for 30 days. At the same time, it probably will not qualify to address any co-tenancy violations.

A variation to pop up leasing is the kiosk or pushcart. Changing kiosks also creates new tenants and like popups, is an easy inexpensive way for a retailer to have a physical presence. Many lease forms prohibit kiosks in certain locations and may be problematic (although an intelligent tenant may decide that having kiosks outside their store is really a good thing that drives traffic to their store). Most kiosk leases are similarly short-term license agreements where the landlord supplies the kiosk for the tenant's use. A holiday program where a line-up of retail booths in the common areas is erected is nothing more than a pop-up leasing program using kiosks or push carts and is exactly the kind of pop up leasing program that brings excitement to a center.

Certain landlords have gone one step further in bringing in on line retailers. They have created "test market" spaces where the storefront, point of sale system, signage, and even employees are provided by the landlord – the only thing the tenant has to provide is its merchandise. The landlord will want the data from the tenant regarding how its on line presence was affected, but otherwise it's a total turn-key operation. This is just a super easy way for a tenant wanting to do a pop-up store to gain the benefits, and a very creative way for landlords to get on line retailers to think about physical locations.

A "store within a store" is essentially a way for tenants to do pop up leasing. The tenant in effect subleases (or licenses) part of its space to another tenant. The "subtenant" does not have a direct entrance to the outside and usually does not have exterior signage. The "subtenant" typically pays gross rent to the tenant and has its sales rung up on the subtenant's own point of sale system. (This raises a unique issue when it comes to measuring the tenant's gross sales for purposes of percentage rent. Many landlords require that a tenant's gross sales include the gross sales of any subtenant. But in this case, the tenant may not even have access to the subtenant's sales. It may be better in this case to have the gross rent paid by the subtenant included in the tenant's gross sales instead of the gross sales by the subtenant.) The tenant is akin to a landlord. A tenant who has excess space and desires to drive additional customers to its store may consider letting another retailer sublease space within the store. Like in the traditional pop up lease, the costs for the subtenant are minimal and the same benefits apply.

(D) Showrooming.

Another retailing model that is becoming more and more common in retail centers across the United States is "Showrooming". Showrooming is defined as when a landlord enters into a lease or license agreement with a tenant to operate their premises for the display of their products or goods so that consumers can examine and inspect them before they purchase the item online. Due to increased online shopping, showrooming has become extremely common with consumers even when visiting traditional retail locations. Many customers are worried about purchasing an item online before physically being able to see the product. Therefore, many consumers will first go to the brick and mortar retail store to look at and test out the item but will not purchase it in the store. They will then purchase the item online because they have found a lower price. Many retailers are trying to combat showrooming by offering special incentives that can only be obtained if the item is purchased in store; some are also going as far as introducing a "fitting fee" to deter customers from just browsing and not purchasing anything.

Landlords are entering into showrooming agreements with some concerns as to how this form of retailing will negatively impact gross sales from the shopping center. Landlords traditionally include sales from the premises in their calculation of gross sales. Due to the fact that showrooms are just displaying items and not actually selling items from the location, Landlords need to add language to their agreements that in the event that sales are made from or are filled from the showroom, such sales will be included in the gross sales of the location. In addition, Landlords will need to structure the economics of such leases to increase the minimum rents to reflect the added value that operating a showroom provides to a retailer while adding a percentage rent factor of any sales that do occur from the location. In order to prevent purchases from being placed or made at the location while customers are actually in the showroom, Landlord can also require Tenant to turn off or prevent from operating in the showroom any WiFi or internet service.

Showrooming can also be a very effective retail technique to operate a location in the shopping center as an incubator for local retailers or operators that are not traditional retailers like artists or custom made items. Landlord can also enter into short term license agreements or space leases to allow for a reduced rent and increased exposure for such retailers and operators. Landlords are also able to bring increased occupancy to their shopping center by taking space that is otherwise difficult to lease and turning it into occupied space generating continuous interest to customers because of its unique products. Showrooming agreements can permit landlords to lease a full space to single tenants, lease portions of the space to multiple tenants or lease shelf space to various tenants for varying amounts of time. Due to the fact that multiple tenants may be displaying their multiple products, Landlord will need to be aware of potential exclusive violations from items that will be showcased in the location.

One example of Showrooming that is being implemented at Washington Prime Group ("WPG") is the Tangible Marketplace concept. Tangible Marketplace is a hybrid form of Showrooming with a traditional retailing structure. Tangible Marketplace is a curated collective of up-and-coming e-commerce purveyors and online brands wanting to be discovered offline, in person so that customers can see, touch, experience and share their products. The locations were built out by Landlord and permit multiple online concepts to showcase their wares for between three (3) to six (6) months at a time under a license agreement. The license agreement contains a fixed monthly fee or variable cost structure depending on the wares and showcasing requested by the concept. The hybrid aspect of this concept is that the online retailers are showcasing their wares to generate interest in their online offerings, but it also allows customers to make purchases from the location on WPG provided iPads and WPG receives an agreed upon percentage of such sales. WPG and the online retailer are then able to track the amount of sales directly from the location. As part of the licensing costs, WPG also provides personnel to manage the location and handle sales and any questions posed by customers. Currently, WPG has rolled out the Tangible Marketplace concept in four (4) locations in its portfolio, including the Polaris Fashion Place in WPG's corporate headquarters home base. Along with the Tangible Marketplace License agreement, WPG also offers the ability for online concepts to purchase a membership to its online Tangible Collective. Through the Tangible Collective, WPG's website will showcase a collective of brands showcased at the location or that were showcased there for a period not less than twelve (12) months. Each concept will be given a jump page which will drive increased traffic and sales to the concepts online website.

(F) <u>Defining Gross Sales</u>.

Defining "Gross Sales" for a multi-channel retailer requires a bit of analysis. Where the tenant pays percentage rent, or may pay alternative rent based on Gross Sales, or has a kick out tied to Gross Sales, it is important to measure Gross Sales fairly.

Generally speaking, it seems appropriate to include internet sales if but only if the order is fulfilled at the store. So where a consumer orders goods over the internet, either from home or on a computer at a store, either another store or the one at issue, the sale will count towards Gross Sales only if the consumer picks up the goods at the store or if the goods are shipped to the consumer from the store, or in other words if the order is fulfilled at the store. Conversely, if the goods are shipped from another store or from a warehouse, the sale does not count towards Gross Sales, even if the order originates from the store. This treatment is akin to gift certificates – a gift certificate is not included in Gross Sales unless and until it is redeemed at the store. So even if it is sold elsewhere, it counts towards Gross Sales if redeemed at the store, while a gift certificate sold at the store does not count towards Gross Sales if redeemed elsewhere. And in each case, this should be how the retailer does its internal accounting of sales.

Similarly, the issue of returns need to be considered. If a consumer can purchase goods over the internet but return them to a store, a retailer's Gross Sales can be artificially reduced. Gross Sales should be defined to allow returns to be deducted only if the goods were originally included in Gross Sales.

The standard landlord form lease provides that the Gross Sales of any subtenant or licensee must be included in the tenant's Gross Sales. In some cases that may be appropriate, but in the case of a store within a store it may not work. The licensee may have its own register and the tenant has no access to any Gross Sales of the licensee. In that case, the license fee or subrent paid by the licensee to the tenant should be included in Gross Sales instead. In this way, the true economic benefit to the tenant is included.

Friday, March 1, 2019
11:45 am – 12:45 pm

Concurrent Session B

PACE is the New Green: How PACE Provides a Green Financing Option for Building Transformation

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I. Basics of PACE

a. What is PACE
b. History of PACE
c. Which states have PACE legislation
d. Growth of PACE

II. Legal aspects of PACE

a. Legal overview of the state legislation and local implementation for PACE
b. How the PACE assessment gets added to the property's tax roll
c. How the PACE assessment can be a pass through to tenants
d. Accounting considerations of PACE

III: What qualifies for PACE

a. Eligible improvements
b. Eligible property types
c. Retrofits vs. new construction considerations
d. Other considerations

IV: PACE Funding Process

a. Underwriting basics - "Filling the Capital Stack"
b. Typical PACE application review
c. Mortgage Lender "consent" and other due diligence considerations
d. PACE loan closings
e. PACE loan disbursements for installation
f. Post installation considerations

V: Case Studies "How PACE actually works"

a. New construction
b. Redevelopment or "gut rehab"
c. Retrofitting existing buildings

VI: Final Questions and Discussion

1. State Authorizing Legislation
    a. What is PACE?
        i. **<u>P</u>**roperty **<u>A</u>**ssessed **<u>C</u>**lean **<u>E</u>**nergy
    b. Who uses PACE?
        i. Over 30 states authorize PACE, thanks to a federal initiative in 2008-2009 to encourage local governments to adopt energy efficiency and alternative energy assessment authority. California's Berkeley First Program and the program in Boulder, Colorado were two of the early adopters.
        ii. Several programs in Ohio were jump-started by the federal ARRA program, including the Toledo-Lucas County Port Authority and the Greater Cincinnati Energy Alliance.
    c. States may have several PACE laws, for various reasons:
        i. Aspects of PACE are often covered in more than one law;
        ii. PACE laws may be passed over time to implement various separate aspects of PACE financing; and
        iii. PACE laws may be amended over time.

2. Special Assessments Generally – Public Use
    a. What are special assessments?
        i. Special assessments are governmental charges, <u>not</u> taxes.
        ii. They are imposed on real property near an improvement and are used to pay the costs of the improvement.
        iii. They are imposed in recognition of the "special benefit" received by the property owner by virtue of the improvement.
        iv. Special assessments are collected like real property taxes.
    b. Special assessments are traditionally imposed for "public use" improvements.
        i. Examples include: roads, sidewalks, lighting improvements
        ii. The "public use" element is fundamental to the use of governmental power to lien property.
        iii. The government's use of this power to lien property generally requires extensive due process, including notices and hearings.

3. Special Assessments for Energy Improvements – Private Use
    a. PACE assessments fund <u>privately-owned</u> improvements, by using existing or modified special assessment laws.
    b. These privately-owned improvements must be "public use" or provide "public good."
    c. States with PACE financing legislation typically adopt PACE laws or rely on state constitutional provisions stating that energy conservation is a "public good."
    d. For these privately-owned improvements, the due process concerns are modified or reduced.
        i. This is because the PACE process is viewed as voluntary; the "special benefit" is obvious or *per se* present when the property owner themselves request that an assessment be placed on the property.
    e. Examples of privately-owned improvements that may be eligible for PACE financing:
        i. Energy efficiency improvements
            1. HVAC
            2. Lighting
            3. Roofs, windows, insulation
            4. Note: Some states/programs require that proposed PACE projects meet energy efficiency savings requirements. The majority rule is that the proposed PACE project must simply show <u>some</u> evidence of energy savings. Some programs may require a showing of 15% savings over code or an even higher percentage.
        ii. Alternative energy improvements
            1. Solar (photovoltaic [PV] or thermal)
            2. Wind
            3. Geothermal

                4. Biomass
            iii. Water efficiency improvements

4. Authorizing Special Assessments
    a. Authorizing legislation is required to impose PACE assessments on real property.
        i. Majority rule: PACE assessments are authorized by <u>local</u> legislation.
        ii. Minority rule (in place in Connecticut): PACE assessments are authorized through statewide programs.
    b. Districts or programs may require any combination of the following:
        i. The formation of a separate legal entity;
        ii. The creation of articles of incorporation, codes of regulation, and board representation;
        iii. Energy audits; or
        iv. Other action items for certain projects.
    c. Generally, the local legislation will expressly authorize the specific energy improvement on a property.
    d. The permitted term for which special assessments may be placed onto property can vary.
        i. Statutes often provide statutory maximum lengths of time for special assessments to be placed.
        ii. There are also bond financing considerations that will control, based on the useful life of the energy improvements being constructed or installed.
    e. The authorization process will require certain notice requirements and apportionment be met (or are waived) by the appropriate parties.
    f. Like taxes and other forms of governmental exaction, special assessments must be perfected in order to be enforceable against real property. Perfection can occur through a variety of procedures:
        i. The local authority's adoption of special assessment legislation;
        ii. The provision of notice of special assessment legislation to the public;
        iii. The provision of notice of special assessment legislation to the appropriate auditor, assessor, or tax collector;
        iv. Recording an instrument establishing the assessment lien on the property;
        v. Or in some cases, a combination of all of the above.

5. Remedies for Delinquency
    a. PACE assessments, like most assessments, "run with the land."
        i. Majority rule: PACE assessments remain with the property upon which they were placed when the property is sold.
        ii. Minority rule: PACE assessments must be satisfied upon sale.
    b. PACE assessments should be viewed as a "tax-like" encumbrance on real property.
    c. State tax foreclosure procedures apply to PACE assessments.
    d. The ultimate remedy if the assessments are not paid is foreclosure of real property.
        i. Majority rule: Delinquent PACE assessments cannot be accelerated.
            1. Note: In these jurisdictions, a PACE assessment is not like a mortgage that can be accelerated. A PACE assessment is more typically characterized as an "expense" or "operating" item on a balance sheet, not a "debt."
        ii. Minority rule: Delinquent PACE assessments are accelerated or are subject to alternative remedies.
        iii. Other rules:
            1. Sale of tax deed
            2. Sale of tax lien certificate
            3. Some form of lien-clearing or land banking procedure
    e. The general result of tax foreclosure will be the satisfaction of all then-delinquent tax items by judicial sale. Post-sale, future taxes and assessments continue to attach and "run with the land."

6. Lien Priority

a. Generally, a delinquent PACE assessment is enforced like a delinquent real property tax and is superior to all private liens.
    i. Majority rule: Taxes are superior to special assessments (i.e. liens are weaker).
    ii. Minority rule: Taxes and special assessments are pari passu (strongest lien status).
    iii. Other rule: Taxes and other special assessments are superior to PACE assessments (weakest lien status).
b. Other liens fall in various places depending on the applicable law:
    i. Federal liens – typically senior to PACE assessments
    ii. Mortgage liens – typically junior, unless the PACE assessment was not perfected
    iii. Mechanic's liens – typically junior
c. Lien-clearing statutes <u>can</u> affect priority of PACE assessments.

7. PACE and Private Lenders
    a. A PACE assessment is afforded great respect in the private credit markets, as an encumbrance on real property.
    b. A lender's views on PACE assessments may vary:
        i. Some may view delinquent PACE assessments senior to delinquent mortgages.
        ii. May see a possibility to reoriginate a loan at a senior position.
        iii. PACE assessments may lead to higher rents on a property.
        iv. PACE assessments may provide some measure of stability in property value.
        v. Improvements associated with the PACE assessments might enhance borrower cash flow or EBITDA.
        vi. PACE assessments may improve balance sheet (since PACE is generally considered an operating expense, not debt).
    c. Mortgages do not permit the creation of senior liens.
        i. But a PACE assessment delinquency would establish a senior lien.
    d. The mere process of requesting a PACE assessment is probably not a mortgage default.
        i. A PACE assessment is not a lien until it is unpaid, and therefore it is not technically a mortgage default until the PACE assessment is (1) requested, (2) perfected, and (3) unpaid.
    e. Mortgagee consent or acknowledgement of the PACE assessments is required.
        i. Majority rule: The PACE project must obtain first mortgagee consent.
        ii. Minority rule: The PACE project may proceed without first mortgagee consent if it is permitted by the mortgage.
        iii. Other rule: The PACE project may proceed with an acknowledgement of the PACE assessment by the mortgagee (in other words, if the mortgagee acknowledges that the mere process of requesting a PACE assessment is not a mortgage default).

8. Federal Regulatory Issues
    a. PACE and residential mortgage underwriting criteria may conflict.
    b. IRS regulations for tax-exempt and tax-preferred bonds may conflict.
        i. PACE financing can be used with tax-exempt bond financing, but only with certain users – governmental and 501(c)(3) – and a healthy respect for IRS regulations prohibiting private business use and private loan financing.
        ii. PACE can also be used with taxable programs like QECB.

9. State Regulatory Issues
    a. States can set higher energy efficiency savings requirements.
    b. There may be stricter requirements or reporting requirements for seeking investor-owned utility credit for improvements.
    c. PACE projects could conflict with state power siting rules.
    d. States may require property owners to procure certain specific types of energy auditor services, contractor services, or other vendor services.

THE FINANCIAL IMPACT OF PACE – AN EXAMPLE

Property where the Landlord provides common area cooling and lighting

Project involves a $200,000 energy efficiency retrofit Annual energy and maintenance savings of $33,000 (6.1 years simple payback)

PACE funding available for up to 20 years

SCENARIO 1 – OWNER-OCCUPIED BUILDING

Key Attributes of owner-occupied buildings

- The owner is responsible for the payment of real estate taxes, building insurance, and common area repair and maintenance expenses
- Recovery of these expenses is through base rent
- Any energy efficiency savings flow directly to the owner's bottom line
- Energy efficiency projects – versus required infrastructure improvement projects - are evaluated on the basis of cash-on- cash return on investment

Similar to owner-occupied buildings: Gross leases; Hotels; multi-family.

Simplifying Assumptions:

Annual Energy Cost Increase: 0%
Annual Maintenance Cost Increase: 0%
PACE financing interest rate: 6%
10-yr horizon for NPV and IRR calculations

	Self Funded	PACE 20 years	PACE 8 years
Investment by owner	($200,000)	$0	$0
Decrease in energy cost	$33,000	$33,000	$33,000
Increase in real estate tax	$0	($17,440)	($32,200)
EBITDA impact	$33,000	$15,560	$800
Cash flow year 1	($167,000)	$15,560	$800
Cash flow year 2 thru PACE term	$33,000	$15,560	$800
Cash-on-cash IRR	13.4%	N/A	N/A
NPV of cash flow (8% discount rate)	$36,000	$104,000	$5,300
Property value increase at 6% cap rate (during financing term)	$550,000	$225,000	$11,000

*PACE increases property value with **no** capital investment by the owner*

SCENARIO 2 – TRIPLE NET LEASES

- Real estate taxes, building insurance, and common area repair and maintenance expenses are "passed through" to tenants on a pro-rata basis based on the relative size (square footage) of the area occupied by each tenant.
- The tenants are typically directly metered and responsible for utilities in their own space
- All energy efficiency savings in the common area generated from investments by the landlord go directly to the tenants' bottom line
- Any increase in real estate taxes can be passed through to the tenants

Simplifying Assumptions

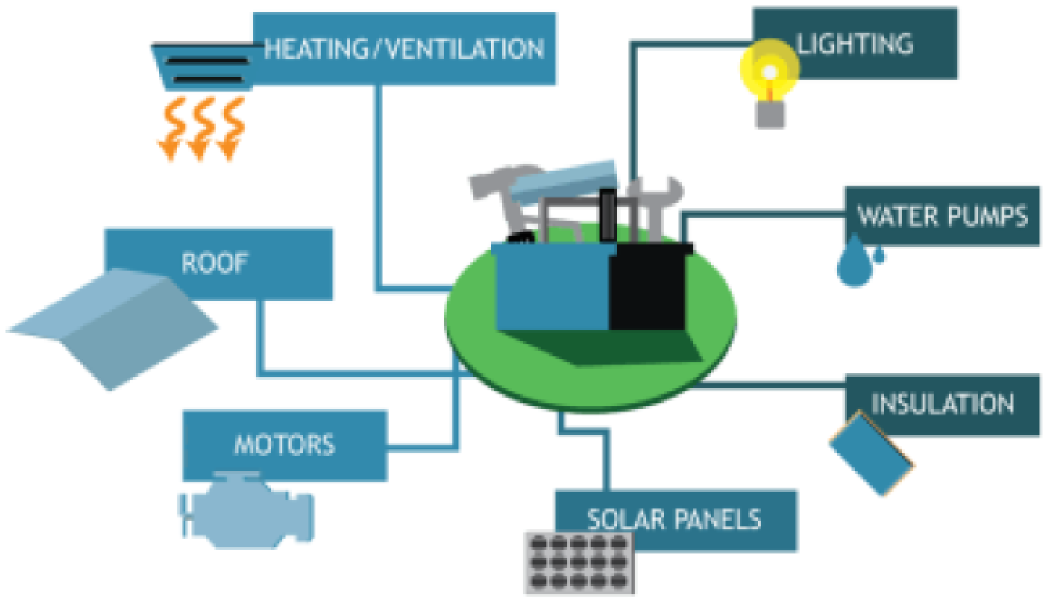
Annual Energy Cost Increase: 0%
Annual Maintenance Cost Increase: 0%
CAM Expense Recovery Rate: 100%
Real Estate Tax Recovery Rate: 100%
Green Lease Clause for CAPEX Recovery: Not applicable
PACE financing interest rate: 6%
10-yr horizon for NPV and IRR calculations

	Self Funded	PACE 20 years	PACE 8 years
Investment by landlord	($200,000)	$0	$0
Decrease in energy cost for LL	$33,000	$33,000	$33,000
Energy savings shared w/tenants	($33,000)	($33,000)	($33,000)
Increase in real estate tax for LL	$0	($17,440)	($32,200)
RET recovery from tenants	$0	($17,440)	($32,200)
EBITDA impact	$0	$0	$0
Cash flow year 1	($200,000)	$0	$0
Cash flow year 2 thru PACE term	$0	$0	$0
NPV of cash flow (8% discount rate)	($200,000)	$0	$0
Tenant annual net savings	$33,000	$15,560	$800

Financing energy efficiency through PACE improves the asset and can lower costs for tenants with ***no*** *capital investment by the landlord*

Qualifying PACE Improvements

- ✓ (HVAC) Heating & Cooling Systems
- ✓ (BAS) Building Automation Systems
- ✓ (CHP) Combined Heat & Power
- ✓ (PV) Solar Photovoltaic
- ✓ Roofing
- ✓ Air Sealing
- ✓ Insulation
- ✓ Windows
- ✓ Elevators
- ✓ High Velocity Ceiling Fans
- ✓ Lighting
- ✓ Demand Reduction Controls
- ✓ Pumps, Motors, and Drives
- ✓ Duct Sealing
- ✓ Other Market-Proven Technologies



Eligible Building Types

- ✓ Office
- ✓ Multi- Family 5+ Units
- ✓ Industrial
- ✓ Agriculture
- ✓ Hotel
- ✓ Retail
- ✓ Non-Profit

What is PACE Financing?

PACE is a simple and effective way to finance energy efficiency and renewable energy building improvements. PACE can pay for qualifying improvements for almost any type of property including commercial, retail, industrial, nonprofit, and multi-family.
Property owners across the United States are using PACE because it saves them money and makes their buildings more valuable. PACE provides financing for 100% of an energy project's cost and is repaid for up to 25 years with a voluntary special assessment added to the property's tax bill.

Why PACE Financing?

No Down Payment
PACE covers 100% of the hard and soft costs of an energy project eliminating the need for up-front capital.

No Personal Guarantee
PACE financing is "guaranteed" by the Special Assessment added to the property's tax bill, therefore, no personal or business guarantees are needed.

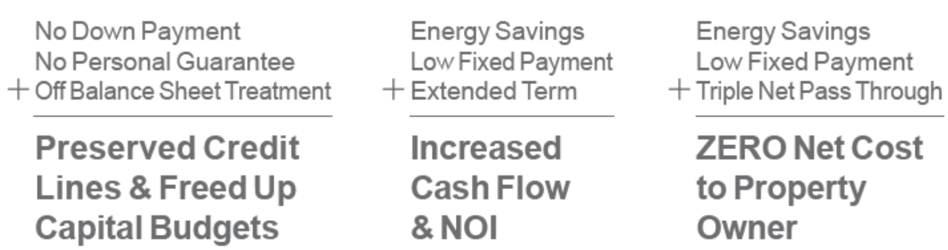
Off Balance Sheet Treatment
Because PACE financing is solely repaid via a Special Assessment added to the property's tax bill, "off balance sheet treatment" is recommended by some accountants because the repayment "runs with the land" and not the business.

Fixed Rate / Fixed Payment
PACE financing rates and terms are fixed for the life of the PACE loan.

15-25 Year Term
Repayment terms can be extended to match the useful life of the eligible improvement.

Triple Net Lease Pass-through
Because repayment of PACE funding is via a Special Assessment on the property's tax bill and is technically an increase in property taxes, the property owner can seamlessly share the PACE-financed improvement costs (and energy savings) with the tenant under some lease structures such as "triple nets".

PACE Benefits for the Property Owner



OHIO PACE Funding Process

1. **Initial Eligibility Form**
   The property owner completes a brief form at OHPACE.org to help PACE determine if the property and potential energy project is eligible for OHIO PACE financing.

2. **Energy Project Summary Form**

The property owner works with a OHIO PACE registered contractor to identify eligible energy saving improvements and quantify the energy savings. This form is submitted with the Energy Project Application.

3. **Energy Project Application**
The application allows the property owner to provide essential financial documentation about the property and its operating status. OHIO PACE provides the information to its network of registered capital providers to obtain PACE financing terms for the owner.

NOTE: The property owner must obtain written consent from the existing mortgage holder before a PACE special assessment can be added to the property's tax bill.

4. **Funding**
The property owner agrees to financing terms and then the PACE special assessment is added to the property's tax bill. After the OHIO PACE financial closing occurs, the funding will be available for the eligible energy saving improvements.

5. **Installation**
The registered contractor completes the installation of the authorized energy saving improvements. OHIO PACE ensures all improvements are installed to the satisfaction of the property owner.

Submit an Initial Eligibility Form at OHPACE.org

About OHIO PACE
OHIO PACE is a program administrator that works with property owners to secure PACE financing for qualified energy projects. It coordinates efforts with local governments and connects property owners with private PACE capital providers and contractors to ensure the successful funding and installation of energy projects.

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OHPACE.org

OHIO PACE is a program of:

Energy Alliance

PROJECT EXAMPLES

These three projects demonstrate the wide variety of ways one can employ PACE in a retrofit, deep rehab, or new build project:

A. PNC Plaza: retrofit project
    - 155 E. Broad Street, Columbus, Ohio 43215
    - 366,769 square foot, 23 story office building in downtown Columbus
    - $3.3mm PACE bond to finance retrofit lighting, roofing, domestic water supply pumps, air handling unit controls, and domestic hot water upgrades
    - Saves property owner $187,600 annually in energy costs, a 15% reduction compared to the prior state of the building
    - Sold to new owner after PACE financing. Special assessment carries seamlessly with the building to the new owner.

B. Trivium Worthington: deep rehab project
    - 350 W. Wilson Bridge Road, Worthington, OH
    - Trivium Development as owner
    - Rehab derelict 53,000 square foot office building into Class A office space
    - Overall redevelopment cost of $11.2 million
    - $325,000 PACE loan to finance LED lighting, HVAC, domestic hot water heater upgrade, and envelope improvements
    - Further supported with mortgage, TIF financing, and borrower equity
    - Saves property owner $48,600 annually in energy costs, a 50% reduction compared to local building codes

C. Trivium Grove City: new build project
    - 5775 N. Meadows Drive, Grove City, OH
    - Trivium Development as owner
    - 41,000 square foot new build medical office building
    - $448,500 PACE loan to finance a building automation system, high efficiency domestic water heaters, roofing, walls, windows, LED lighting, and HVAC system
    - Saves property owner $59,450 annually in energy costs, a 67% reduction compared to local building codes

Friday, March 1, 2019
2:30 – 3:30 pm

Concurrent Session A

The Doctor Is In: An Evolving Market for Medical Leasing

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SMALL FORMAT HOSPITALS

1. US RETAIL TRENDS
    a. Reuse and repurposing of commercial and retail spaces
        i. Increased competition
            1. Online shopping
            2. Catalogues and mail order
            3. Television shopping networks
        ii. Decreasing number of commercial occupants
            1. Closing of anchor stores
            2. Retail centers vs. main street locations
        iii. Increased need to repurpose commercial space
    b. Hospitals and clinics in previous or currently zoned commercial space
        i. Health care consumers and comparison shopping
            1. Affordable Care Act marketplace
            2. Non-hospital alternatives
        ii. Needs of small-format hospitals and retail health
            1. Locations with traffic
            2. Proximity to clients

2. HOSPITAL TRENDS
    a. Patients and hospitals want care provided closer to home
        i. Deficit of primary care doctors
        ii. Outpatient care
        iii. Preventative medicine and wellness initiatives
        iv. Healthcare system involvement in retail medicine and retail clinics
        v. Rise of virtual care
    b. Overview of small-format hospitals and Allegheny Health Network innovations
        i. National trends for small-format hospitals
        ii. Services provided
        iii. Difference between urgent care, retail clinics, and small-format hospitals
        iv. Connection to other ambulatory and medical sites
        v. Licensure
        vi. Benefits to community
        vii. Benefits to providers
        viii. AHN Innovations
    c. Drivers and reasoning for small-format hospitals

        i. Access to Care in Regional Locations Imperative
        ii. Wexford Hospital case study
        iii. Waterworks clinic case study
        iv. Other case studies

3. ADAPTIVE REUSE FROM A HEALTH CARE PERSPECTIVE
    a. Design challenges
        i. Preferred structure
        ii. Internal layout
        iii. Traffic and ambulance circulation
        iv. Parking
        v. Patient access
    b. Legal challenges
        i. Department of Health Regulations
        ii. Building Code and use classification

4. LEGAL CHALLENGES FOR REUSE AND SMALL-FORMAT HOSPITALS
    a. Compliance with local regulations which do not contemplate small-format hospitals
        i. Subdivisions and Land Development Ordinances
        ii. Zoning Ordinances
        iii. Building Codes
        iv. Department of Health
        v. PennDOT
    b. Community involvement
        i. Community involvement strategies
        ii. Local government
            1. McCandless small-format hospital
            2. Brentwood small-format hospital
        iii. Residents and community groups
        iv. Objectors
    c. Legal challenges
        i. Land use
            1. Zoning
            2. SALDO and other local codes
            3. Agency appeals
        ii. Anti-trust
            1. Legal challenges from competitors

2. Non-legal involvement of competitors

5. CHALLENGES IN LEASING AND FINANCING
    a. Overview of leasing and financing
        i. Comparison of traditional health care and small-format hospitals
        ii. Comparison of retail heath and small-format hospitals
        iii. Unique challenges in leasing retail spaces for small-format hospitals
            1. Landlord restrictions on medical use
            2. Exclusivity provisions
            3. Tenant mix
            4. After hours access
            5. Utilities
            6. Relocation provision
            7. Landlord inspection and privacy
            8. Anti-kickback
        iv. Challenges for reuse of commercial space
            1. Base building infrastructure
            2. Tenant improvement costs
            3. Accessibility
        v. Leasing Solutions
            1. Lease structure
            2. Necessary provisions
        vi. Challenges in financing small-format hospitals and solutions
    b. Harmar small-format hospital case study
    c. Brentwood small-format hospital case study
    d. McCandless small-format hospital case study
    e. Other case studies

Friday, March 1, 2019
2:30 – 3:30 pm

Concurrent Session B

That Was Then, This is Now: Dealing with Existing REA's in Today's Evolving Retail Centers

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This program addresses the real-world pressures and challenges regarding compliance with the provisions of existing Reciprocal Easement Agreements vis-à-vis today's significant evolution and redevelopment of retail centers.

OVERVIEW

Value Enhancement/Economic Concerns:

- Centers are in a continual state of evolution: indoor shopping malls to modern "power centers" with big boxes/national tenants, and then to lifestyle centers; change of product type to stay relevant to modern consumers

- "Redevelopment": construction or renovation of one or more buildings in existing center; may or may not involve demolition of existing buildings; often includes reworking of access, common areas, parking and signage

- Jones Lang LaSalle Report summarizing 90 significant mall renovations in 2017: top spending priorities were (i) food/fun, (ii) physical upgrades/tenant improvements, and (iii) creating open space for community use

- Modernizing: reader boards, WiFi, security needs, electric car charging stations, integration of online sales/in-store pickup, ADA parking/access, security

Current Trends:

- Adding density
- Experiential retail and entertainment
- Hotels
- Office
- Multi-family
- Repurposing vacant big-box stores

INITIAL DUE DILIGENCE

- Business deal that has been agreed upon by parties
- Parties to the REA; who is the "Developer?"
- Documentation
- Title
    - Restrictive covenants regarding development imposed in deeds, or by public entities in connection with incentives, etc.
- Special Considerations regarding Anchor Tenants
    - Do some anchor tenants own their own parcels?
    - Rights of first refusal of anchor tenants to purchase their parcels upon redevelopment
- Lender/Investor Considerations
    - Consents may be necessary from lender and/or equity investors (CMBS pool loans may prohibit additional debt and/or borrower's ability to modify existing collateral such as a major physical change in center)
- Term/Priority of the REA
    - Does the REA have an expiration date (?)
- Zoning/Permits/Approvals necessary for new site plan/redevelopment

PRACTICAL ISSUES

- Access/Parking

- Utilities

- Signage

- Construction/Relocations

  - Special issues with tenants remaining open during redevelopment (access, safety, parking, signage, dust, dirt, noise, loss of customers: breach of quiet enjoyment?)

  - Do leases contain operating covenants, blackout periods?

  - Do tenant leases permit relocation? If not is lease buyout feasible?

- Exclusive/Prohibited Uses

  - Historic prohibited uses in original REA may now be inappropriate and/or not enforceable (e.g., massage parlors, gun ranges, tattoo parlors, medical office, entertainment, gyms); is it safe to ignore these as long as uses are "typical" in today's centers?

- Site Plan: no-build, protected parking, permitted building areas: can these be modified?

- Outparcels

  - Certain parcels may be defined as "Outlots" in the original REA but have subsequently been reconfigured to be a portion of the "Developer Parcel" to which different restrictions now apply

- Consent/Approval Rights

  - Are there tenant lease provisions restricting changes to Common Areas?

    - *Lord & Taylor LLC v. White Flint L.P.* 4th Circuit 2017; tenant can hold developer hostage re redevelopment – "beg for forgiveness instead of asking for permission" – developer wanted to redevelop a failing mall, L&T had consent rights; developer proceeded with redevelopment and ultimately was ordered to pay L&T $31mm in damages, including potential lost profits

  - Do tenant leases have rights of first refusal?

  - Expense/time involved to obtain necessary consents/approvals

FACTORS/CONSIDERATIONS THAT MAKE A NEW REA NECESSARY

- Has the overall site plan been significantly reconfigured since the adoption of the original REA? (i.e., is product type changing, such as 'de-malling' to convert an enclosed mall into open air lifestyle center?)

- Are types of tenants changing?

- Can existing documentation accommodate the desired changes?
- Has the original REA been amended numerous times, making it difficult to interpret?
- Have parties/real estate changed?
- Do existing restrictions limit redevelopment of big boxes? (i.e., number of entrances, exterior features, building footprint, traffic patterns, parking, access, visibility, sharing of utilities)
- Is the Original Developer “out”? (i.e., Original Developer no longer owns any portion of the real estate)
- What about anchors and other tenants whose use has changed since the original REA?
- Are there “implied” restrictions in the original REA that may limit or prohibit expansion/redevelopment? e.g., attachment of original site plan (does this create an implied representation that buildings/improvements will not change?); definition of “shopping center” that includes outparcels or after-acquired property
- Are any condominium regimes involved?

DEFINITIONS

- Cross easements for use of the enclosed mall, other common areas, ring road, common utilities facilities, construction easements, footings easement, and self-help easements

- Requirements and protocols to submit plans to the applicable parties for construction of the original center and alterations

- Requirements for construction (scheduling, staging, compliance with law, insurance)

- Changes to the site plan

- Maintenance, repair and restoration of buildings

- Maintenance, repair and restoration of the common area

- Parking requirements and ratio

- Prohibited uses at the project, as well as limitations on certain uses

- Signage criteria

- Transfer or conveyance of parcels

- Insurance

- Condemnation

- Payment of real estate taxes

- Term

- A governing site or plot plan

- Building height limitations

- Rules, regulations and maintenance standards

- Supplemental agreements between the Developer entity and the anchor stores

RESTAURANT CONSIDERATIONS

- Restaurant use and potential exclusives
- How is the outbuilding to be serviced with parking? Will it be dedicated parking, or will it be shared?
- Will existing "no-build" areas need to be reconfigured?
- Height restrictions
- Exterior signage (probably not addressed in REA as it was not envisioned)
- The right to subdivide the tract
- If the primary tract is subdivided, who will be a party/designated party to the REA?
- If the outbuilding is being constructed on an anchor store's parcel, may it compete with existing retail on the Developer parcel?
- Does the use clause in the REA, as it pertains to the anchor store tracts, have to be amended to allow for expanded or different uses?
- Does the Developer have any issues with expanded and varied uses on other anchor store tracts if it has granted exclusives to existing tenants on the Developer's tract?
- Restaurants often want the right to operate an outdoor patio on adjacent sidewalk (part of Common Areas)

HOTEL CONSIDERATIONS

- Height restrictions
- Franchisor requirements
- Parking (based on code or number of rooms)
- Valet drop off/pick up locations
- Number of rooms
- Ballrooms and/or meeting rooms
- Restaurants (violation of existing exclusives/restrictions)
- Small retail shops (again, any concern with existing exclusive/restrictions)

OFFICE BUILDING CONSIDERATIONS

- Identify area(s) where office building can be located
- Height restrictions
- Restrictions on particular uses within the office buildings (e.g. no governmental agencies?)
- Parking (can parking for the office building during off hours be used to support retail tenants?)

MULTIPLE/COMPETING REA'S

- "Mini REA" between Developer and anchor/outparcel buyer; acknowledges existing REA, adds easements, cost-sharing provisions that apply only to the outparcel, protections with respect to changes to the existing REA that could adversely affect anchor (some national users may insist on being ‘carved out’ of the original REA except for universal issues such as nuisance and exclusive uses, access/parking, and other cross-easements)

- Supplemental REA’s and side agreements may be needed to “get the deal done” when an Amendment to the existing REA may take too long

- Does the original big box anchor consider the additional major user to be a “big box”/anchor?

- Identify other shopping centers in other locations (ideally the same geographic region) where both retailers have co-located in harmony and utilized a document that both retailers have previously agreed upon (ideally with the same in-house counsel and real estate managers); “Horse trading” among retailers re permissible building areas, parking ratios/configuration, signage

- If the center is large enough, Developer may propose different control zones, where the respective anchor retailers have separate control over site plan and use issues in their respective zones, with a master REA to incorporate universal issues

- Certain conflicts between the original REA and a subsequent REA (recorded after the original REA) may also arise and in certain instances be addressed as follows:

    - New REA can acknowledge original REA and that in the event of any conflict, the new REA will control vis-à-vis matters that pertain solely to and between the new major department store parcel and the Developer parcel

    - New REA may address existing tenants and require Developer to enforce the new REA with respect to existing tenants except as to any provisions of the new REA that “conflict” with existing tenant leases; “conflict” shall be deemed to exist if a provision in the new REA is more restrictive than, or imposes a requirement not imposed in, an existing lease as listed on Exhibit

    - New REA may require the Developer to refer to the new REA in promulgating rules and regulations for the center with respect to an existing tenant; may also provide that any tenant leases entered into after the recording of new REA are subject to new REA, even if the leased premises and/or the terms of the new tenant lease is substantially similar to a tenant lease that existed prior to new REA

    - New REA may prohibit Developer from extending the term of an existing tenant lease unless such extension subjects the existing tenant to new REA; also may require Developer to consider the provisions of new REA when Developer receives requests for assignments or subleases from existing tenants

Friday, March 1, 2019
3:45 – 4:45 pm

Concurrent Session A

Assumption, Rejection or What's Behind Door No. 3: What's a Landlord to Do About Sales of Leases in a Retail Chapter 11 Bankruptcy?

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Assumption, Rejection or What's Behind Door No. 3: What's a Landlord to Do About Sales of Leases in a Retail Chapter 11 Bankruptcy?

As 2017 came to a close, many landlords hoped that the worst was over. 2017 saw a record number of retail Chapter 11 filings; familiar names such as Payless Shoes, The Limited, hhgregg, Toys r Us and Gymboree all sought protection under Chapter 11 of the Bankruptcy Code. Many of these companies dreamed of a successful reorganization, of being able to move forward and continue to provide goods and services to their faithful customers. Unfortunately, in many cases, these dreams turned to nightmares as a number of these iconic names disappeared from the retail landscape. Over 3,200 store locations store locations closed during 2017. Surely, landlords thought, 2018 would be better.

It was not to be. 2018 saw a continuation of the "Retail Apocalypse" as hopeful reorganizations turned to liquidations, and additional familiar names sought protection under Chapter 11 of the Bankruptcy Code. Since the close of 2017, events related to big names in retail include:

A. Toys R Us: Filed in September 2017 with hopes of a going concern sale that would allow it to move forward, albeit on a smaller scale. Ultimately, these hopes were dashed and Toys R Us closed all store locations and liquidated substantially all of its U.S. assets.
B. Nine West: Closed all store locations and sold the Nine West brand. The company is attempting to reorganize its business around other owned brands including Anne Klein and Gloria Vanderbilt.
C. Claire's: The discount jewelry retailer entered bankruptcy in March and confirmed a reorganization plan in October. Along the way, Claire's shuttered approximately 5,000 locations worldwide, including 150 in the United States.
D. Tops: The grocery chain sought protection in February and exited bankruptcy in October after closing 15 store locations.
E. Southeastern Grocery: The parent of the Winn-Dixie and Bi-Lo grocery chains exited bankruptcy in June. Over 100 store locations were closed during the pendency of the bankruptcy case.
F. The Bon-Ton Stores: The more than century old department store chain began wholesale liquidation efforts shortly after filing bankruptcy in February, and ultimately closed all of its 250 store locations.
G. Brookstone: The specialty retailer filed for bankruptcy protection in August and announced plans to close all of its 101 mall locations.
H. Rockport: Shortly after filing its May bankruptcy filing, Rockport announced the closing of all of its stand-alone retail store locations. Rockport's brands and other intellectual property were ultimately sold to private equity firm Charlesbank Capital Partners.
I. Mattress Firm: The Houston based sleep shop chain filed Chapter 11 on October 5th and, within several weeks, confirmed a pre-packaged plan of reorganization that allowed it to exit bankruptcy by mid-November. During its brief stay in Chapter 11, Mattress Firm closed approximately 650 stores.

J. Sears: The iconic retailer filed Chapter 11 on October 15. On January 17, 2019, Sears announced that ESL Investments, a hedge fund controlled by Sears' largest shareholder, Eddie Lampert, had prevailed in the auction for the iconic retailer's assets. ESL has announced its intention to continue operating approximately 425 stores under the Sears banner. To date, Sears has announced the closure of approximately 250 store locations.

K. Gymboree: The children's clothing retailer filed its second Chapter 11 case in three years, and announced the closure of all its 900 store locations. Gymboree previously filed for Chapter 11 protection in 2017, when it closed 380 stores in an attempt to reorganize its business operations.

<u>REASONS FOR RETAIL APOCALYPSE</u>

While every case is unique, several themes have become apparent in this most recent surge of retail bankruptcies:

1. <u>Decline of Physical Retail.</u>

The "Amazon Effect". With the shift to e-commerce, fewer and fewer customers are shopping at big-box physical retailers and malls. Additionally, many of these iconic retailers have lost the cache they once had as new direct-to-consumer brands with a focus on specific products have taken off.

2. <u>Digital Laggards.</u>

A surprisingly large number of big-box retailers either failed or were too slow in establishing an online presence. With the rise of Amazon and digitally native direct-to-consumer brands, retailers that failed to adapt quickly to the new marketplace were unable to compete.

3. <u>Mounting Debt.</u>

Crippling debt, in many cases fueled by post-financial crisis leveraged buyouts by private equity firms, has forced many retailers into bankruptcy. Over 20% of all retailers acquired by private equity firms over the last 15 years have filed bankruptcy.

4. <u>Changes in Consumer Spending</u>

Young people are spending less money on clothing and furnishings, and more on experiences they can post on social media such as travel and dining out. As Millennials are set to overtake Baby Boomers as the largest consuming class this trend is particularly alarming for the housewares and apparel industries.

5. <u>Too Many Malls</u>

Even before the e-commerce boom, the U.S. was considered over-stored. The U.S. has more than five times more retail space per person than France, Japan and the U.K. This was largely the result of investors pouring money into commercial real estate decades ago as the suburbs boomed. These buildings needed to be filled with stores, which resulted in the birth of big-box retailers. These big-box stores often served as anchors for the specialty retailers that fed off the mall traffic these anchors generated. As these anchors have sunk, they have often dragged their fellow mall tenants down with them.

Primarily as a result of the factors listed above, it is estimated that over 16,000 store locations have or will close since the beginning of 2018. While many of these store closings were unrelated to any bankruptcy filing, over 3,000 store locations were closed in connection with bankruptcy proceedings. Set forth below is a chart listing those stores closed as a result of recent bankruptcy filings:

Debtor	**Filing Date**	**Court**	**Stores Closed**
A'Gaci	January 9, 2018	W.D. Texas	25
Kiko USA	January 11, 2018	Delaware	25
The Bon-Ton Stores	February 4, 2018	Delaware	250
Tops	February 21, 2018	S.D.N.Y	15
The Walking Company	March 6, 2018	Delaware	25
Claire's	March 19, 2018	Delaware	150
Southeastern Grocery	March 27, 2018	Delaware	100
Nine West	April 6, 2018	S.D.N.Y	70
Bertucci's	April 15, 2018	Delaware	30
Rockport	May14, 2018	Delaware	75
Brookstone	August 2, 2018	Delaware	100
National Stores	August 6, 2018	Delaware	185
Samuel's Jewelers	August 7, 2018	Delaware	45
Toys R Us	September 18, 2017	E.D. Virginia	675
Mattress Firm	October 5, 2018	Delaware	650
Sears	October 15, 2018	S.D.N.Y	250
David's Bridal	November 19, 2018	Delaware	0
Gymboree	January 16, 2019	E.D. Virginia	900
Charlotte Russe Holding	February 3, 2019	Delaware	94
Things Remembered	February 6, 2019	Delaware	250

Filing Locations.

Interestingly, unlike 2017, when retail bankruptcy cases were filed in various courts throughout the country, we seem to have returned to the more typical scenario where large retail cases are almost exclusively filed in Delaware and the southern District of New York.

There are a number of reasons why debtors often opt to file in these jurisdictions, including:

1. Proximity to lenders and other parties in interest;
2. Familiarity of judges with business/bankruptcy interplay;
3. Extensive use of technology;
4. Established body of bankruptcy case law, particularly related to sales of assets in bankruptcy; Procedures for payment of professional fees;
5. Speed and efficiency; and
6. Familiarity with judges, counsel and court personnel.

UNEXPIRED LEASES IN BANKRUPTCY

A. General Rules
   1. Section 365 of the Bankruptcy Code authorizes a debtor to assume or reject any unexpired lease
   2. Assumption is basically a decision to retain a lease.
   3. Rejection is essentially a decision to terminate a lease.
   4. Debtor must cure monetary defaults to assume a lease.
   5. Special rules governing assignment of leases.

B. Leases governed by Section 365
   1. Must be lease transaction.
   2. Sale or disguised secured transaction not governed by Section 365
   3. Must be unexpired.
   4. State law determines whether a lease has been terminated pre-bankruptcy.
   5. Redemption period during which tenant may cure defaults.

C. Timing Issues
   1. Debtor has an initial 120-day period to determine whether to assume or reject a lease.
   2. Debtor may obtain one 90-day extension by leave of bankruptcy court. These requests are generally granted.
   3. Subsequent extensions require written consent of landlord.

D. Assumption

1. Motion to assume filed with bankruptcy court.
2. Cure monetary defaults or provide assurance of prompt cure.
3. Compensate landlord for actual pecuniary losses.
4. Provide adequate assurance of future performance.

E. Rejection

1. Motion to reject filed with bankruptcy court.
2. Vacate space and return to landlord
3. Broom clean condition, return keys, alarm codes.
4. Rejection of a lease may result in various claims to be asserted by landlords, including:
    a. amounts owed pre-petition, which should be allowable in their entirety as an unsecured claim.
    b. postpetition rent claim, which is entitled to administrative expense treatment.
    c. year lease rejection damages claim (unsecured), which is calculated pursuant to formula set forth in §502(b)(6) as the greater of (i) one years' rent or (ii) fifteen percent of the remaining term under the lease, not to exceed three years.

F. Assumption and Assignment

1. Debtor may assign lease despite anti-assignment provision in lease.
2. Comply with requirements for lease assumption regarding cure of defaults and adequate assurance requirements.
3. Landlord can require deposit or other security from assignee.

G. Special Provisions for Shopping Centers

1. Assurance that assignee has same ability to pay rent as original tenant.
2. Any "percentage rent" will not decline substantially.
3. Assignee subject to lease requirements regarding such as radius requirements, use of premises and exclusivity provisions, and will not breach any other lease, finance agreement or master agreement related to the shopping center.
4. Assignment will not disrupt any tenant mix or balance in shopping center.

SALE OF LEASES IN BANKRUPTCY

While many landlords are familiar with the assumption and rejection procedures set forth above, 2018 saw a continuation of a growing trend in bankruptcy cases: the sale of a debtor's interest in an unexpired lease of nonresidential real property. Simply put, the sale of leases offers debtors an opportunity to monetize estate assets that in most cases (i) fails to provide a financial return to the estate and (ii) results in large rejection damage claims against the debtor's estate. Attempts to monetize this particular asset have met with varying results. Nevertheless, it behooves landlords to be aware of this trend, and the attendant risks and opportunities presented.

History

The marketing and sale of leases in bankruptcy is not a novel concept. Recently, debtors in the chapter 11 cases of *Toys R Us*, *The Bon Ton Stores* and *Sears* have employed this strategy to varying degrees of success. *Toys R Us* has sold over fifty leases, while *Bon Ton* has been able to sell less than ten. In the past, debtors such as *Mervyns LLC*, *The Sports Authority*, *Linens Holding Co*., *Sharper Image*, *Freedom Rings, LLC* and *Montgomery Ward Holding Co.* all employed this strategy, again to varying degrees of success.

Advantages to the Sale of Leases

From a debtor's perspective, there are a number of reasons for pursuing a sale of its leasehold interests:

A. Funds realized from sale: The funds received from the sale of a lease may be significant, depending on the value of the underlying lease.
B. Possible avoidance of payment of cure costs: In many instances, the cure cost may be paid by the buyer.
C. Reduce costs of sale: The amounts received by the debtor's broker may be less than the costs accrued if the debtor handled the sales internally. Attempts to limit broker to receiving commission only, avoid up-front costs.
D. Avoid rejection damage claims: These typically large claims may be avoided by selling the lease.
E. Avoid various landlord claims: Any other claims held/asserted by a landlord may be dealt with in the sale process.
F. Ability to select replacement tenant: In a reorganization setting, the debtor retains the ability to select successor tenant. Critical in industries where debtors may have more than one store in a particular area and wants to keep competition from moving into the area. Think about how stores selling a similar product, such as mattresses, tend to be clustered together.

Process for Lease Sales

The legal process typically used in connection with a sale of a debtor's rights under unexpired leases of non-residential real property includes the following steps:

A. Retention of a broker to market and sell the leases
   1. Retention application must be filed and approved by the bankruptcy court
   2. Payment terms must be included in retention application
   3. Broker to assist in identifying leases suitable for sale
   4. Negotiate with prospective buyers

5. Design marketing plan

B. Modifications to Existing Leases

Landlords are understandably nervous when a tenant files bankruptcy. If a lease is rejected, the landlord must (i) move quickly to locate a new tenant to fill this suddenly available space and (ii) often make significant expenditures to the space to fulfill the new tenant's needs. Consequently, debtors often seek to use the leverage they have during the post-petition, pre-rejection period to modify existing lease terms. Indeed, debtors often create artificial short deadlines in an attempt to force landlords to act quickly on the proposed modifications if they wish to avoid rejection of the lease. Further, debtors often provide that such modifications are not subject to court approval. Among the modifications often sought by debtors are:

1. A period of occupancy without paying rent and other charges
2. Reduction of rent for the remainder of the term of the lease
3. Reduced CAM charges
4. Longer grace periods to cure defaults
5. Reduction in space occupied by debtor
6. Elimination of guarantees

C. Motion to Approve Sale Procedures and Approve Sales

1. Two-step process: (i) approval of rules governing sale of leases and (ii) approval of actual sale.
2. Auction vs. Private Sale
3. Qualified Bidder determination
4. Treatment of landlords
5. List leases available for sale
6. Bid deadline
7. Process for submitting bids/date of auction
8. Deadline to object to proposed sale procedures
9. Stalking-horse

D. Notice of Auction Results

1. Identifies proposed assignee
2. Sale Amount
3. Proposed cure amount
4. Date of sale hearing
5. Deadline to object to sale and/or proposed cure amount
6. Often will include draft of transfer/assignment agreement (see case study below)

E. Sale Hearing

1. Draft sale order distributed prior to hearing
2. Objections to sale
3. Remaining objections to proposed cure amounts. These are often left open to a later date to allow for additional negotiations
4. Resolve issues regarding terms of sale order
5. Resolve any adequate protection issues
6. Entry of sale order

F. Additional Considerations

1. Debtors may request streamlined procedures for additional sales
2. Debtors often request lease concessions from landlords including (i) reduced rent, (ii) reduction in other charges, and/or (iii) additional time to decide whether a lease should be assumed or rejected. In exchange, Debtors may offer (i) waiver of avoidance actions, (ii) payment of legal fees to document agreement, and (iii) agreement not to reject lease for a period of time.
3. Private sales often involve limited notice.

Landlord Issues

Each step set forth above may create issues for landlords. While each sale process is unique, Debtors often provide landlords with limited time to review the process and any documents and information provided. It is, therefore, imperative that landlords stay vigilant throughout the sale process. Below are issues landlords should consider at each step of the sale process.

A. Broker Retention

1. Potential business conflicts with the broker.
2. Experience and expertise of the proposed broker.
3. Fairness of fee/commission structure.
4. Marketing budget.
5. As a general rule, the bankruptcy court will respect a debtor's choice of broker.

B. Sale Procedures

1. Review list of leases available for sale closely. A debtor may refer to a given lease in an unfamiliar manner.
2. There are a number of reasons why a lease may not appear on a list. The debtor may (i) plan on assuming or rejecting the lease, (ii) be unaware the lease exists, (iii) plan on listing it at a later date, or (iv) be hoping to renegotiate lease terms, after which it may make its ultimate decision regarding the lease.

3. Reasonableness of proposed timeline and deadlines
4. Reasonableness of protections offered to stalking-horse bidder.
5. Are landlords automatically "Qualified Bidders"?
6. Can landlords credit bid amounts owed by the debtor?
7. Do landlords have to post a deposit?
8. Procedure for obtaining information regarding leases available for purchase.
9. Accuracy of information provided.
10. Opportunity to match highest bid. Particularly important in the event of a private sale.
11. Is listed lease an "unexpired lease".
12. Consider retaining counsel.
13. Consider bidding on lease, particularly if lease terms are well below market rates.
14. Know the value and desirability of your lease.

C. Notice of Auction Results

1. Accuracy of cure amount.
2. Receipt of adequate assurance information regarding purchaser and sufficient time to review same.
3. Responsibility for year-end adjustments such as CAM charges, insurance and taxes. Who will pay and when. Make sure this is clear and in writing.
4. Effect of buyer on current tenant mix.
5. Effect of buyer on landlord's future development plans.
6. Will presence of buyer violate terms of other existing leases or master agreements? In *Toys R Us,* the court overruled objections along these lines, allowing a sale to a buyer whose presence in the landlord's shopping center appeared to breach an existing lease with another tenant.
7. Review of financing agreements
8. Cost to renovate space if objection to proposed sale is sustained.
9. Analysis of any existing sub-leases.
10. Review deadlines for reasonableness.
11. Cost of objecting. Time and resources.
12. Review terms of any agreement between debtor and purchaser.
13. If necessary, request additional time to review/object. Often this can be done informally, particularly where the extension date is still prior to the sale hearing.
14. Opportunity to object by offering higher bid.

D. Sale Hearing

1. Review proposed order.
2. Confirm order includes any agreed-upon terms.

3. Reservation of rights.
4. Contact other landlords regarding potential issues/arguments.

E. Additional Considerations

1. Reasonableness of any streamlined procedures.
2. Consider becoming “Notice Party”, entitled to be noticed of any sale-related issues.
3. Possible exposure on avoidance actions.
4. Debtors often impose arbitrary deadlines, don’t be afraid to push back.
5. If the debtor states that your lease will be assumed, get it in writing.
6. Whenever possible, obtain written court approval of any agreement with the debtor. Debtors often state that such approval is not necessary. Remember, court approval is generally required for any action taken by a debtor that is outside the ordinary course of business.
7. Be extra careful when dealing with private sales.
8. If the debtor offers to pay legal fees, be very specific as to how much will be paid. Debtors often provide a pool of money to pay such fees to landlords – it’s not always enough.

Case Study: *Toys R Us*

On September 17, 2017, Toys R Us and its affiliates (the “Debtors”) filed for protection under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Eastern District of Virginia (the “Bankruptcy Court”). Toys R Us and Brea 1 (the “Landlord”) were parties to a lease (the “TRU Lease”) entered into on December 20, 1996 for a parcel in a shopping center referred to as Brea Union Plaza (the “Shopping Center”). On March 23, 2018, the Bankruptcy Court entered an order establishing bidding procedures to be used in connection with the auction sale (the “Auction”) of certain of the Debtors’ assets, including the TRU Lease.

At the conclusion of the Auction, the Debtors designated Festival Development Corporation (“Festival”) as the successful bidder and Burlington Coat Factory (” Burlington”) as the backup bidder. Festival subsequently withdrew its bid, and the Debtors filed a notice proposing to assume and assign the TRU Lease to Burlington. The Landlord objected (the “Objection”) to the assignment of the TRU Lease to Burlington based upon, among other things, the Landlord’s assertion that such an assignment would violate the terms of an existing lease (the “Ross Lease”) between the Landlord and Ross Dress for Less (“Ross”).

The Ross Lease contained an exclusive use clause prohibiting the Landlord from leasing space in the Shopping Center to any party that would, like Burlington, use the space for off-price sale. Consequently, an assignment to Burlington would violate section 365(b)(3) of the Bankruptcy Code which, in brief, prohibits the assignment of a lease where such assignment would breach of the provisions of a lease with another tenant in a shopping center.

In Overruling the Objection, the Bankruptcy Court found (i) the TRU Lease pre-dated the Ross Lease and did not include a provision requiring compliance with the use restriction contained in the Ross Lease, or in the alternative (ii) the prohibition in the Ross Lease only applied if the Landlord "has the capacity to do so." The Bankruptcy Court found that its approval of the assignment to Burlington pursuant to section 365 of the Bankruptcy Code would leave the Landlord without the capacity to prevent Burlington's intended use of the property. Consequently, there would be no violation of the provisions of section 365(b)(3) of the Bankruptcy Code if the TRU Lease was assigned to Burlington. The Landlord timely appealed the ruling of the Bankruptcy Court, but the appeal was ultimately dismissed.

Query: Would the decision have been different if the TRU Lease had a provision prohibiting any assignment that would violate the terms of another lease with the shopping Center such as the Ross Lease or would the Bankruptcy Curt have found such a provision to be void like many other anti-assignment provisions commonly found in leases? What about the Bankruptcy Court's second rationale? Would that hold up on its own?

Landlord Opportunities

Debtor lease sales may provide opportunities for landlords beyond simply providing a substitute tenant. In addition to purchasing their own leases, landlords, RIETs and financial institutions have purchased leases in shopping centers belonging to others. This may be prudent if (among other reasons):

1. The lease terms are well below market.
2. The landlord knows he can "flip" the lease at a profit.
3. The landlord has an existing tenant looking for such a location.
4. The landlord has some agreement with the other landlord that is mutually beneficial.

However, once the lease is purchased, the landlord must pay all amounts due thereunder. Consequently, this strategy does involve a degree of risk on the part of the landlord.

Take-aways

1. Lease sales are here to stay. As more retailers are forced to seek bankruptcy protection, the sale of leases is likely to become more prevalent.
2. Much of a landlord's strategy in lease sale situations depends on knowing the value of one's property and the ease/cost of locating a new tenant.
3. Always note target dates and deadlines. If you need more time, ask for an extension.
4. Always get agreements in writing. Where necessary, insist upon court approval.
5. If an opportunity presents itself, be ready to act. Things can move quickly in bankruptcy court.

Friday, March 1, 2019
3:45 – 4:45 pm

Concurrent Session B

Cybersecurity is the New Black: How are You Securing Your Data?

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Section 1: Practical

- Anatomy of a breach
- Protected information
- Contractual concerns

Section 2: Legal

- State and federal laws in effect
- State and federal laws in effect soon

Section 3: Technical

- Technical safeguards
- Legal, ethical, and other considerations
- On the horizon, including IoT, smart homes/buildings, and interconnected apps

SECTION I
BY: NICHOLAS S. CERNI

ANATOMY OF A BREACH – MARRIOTT

The facts:

Marriott is a multinational hospitality company that manages and franchises a portfolio of hotels and lodging facilities, including more than 6,500 properties in 127 countries. Marriott recently purchased Starwood Hotels, creating the largest hotel chain in the world. Starwood operates as a subsidiary of Marriott.

Through a reservation database, Marriott and Starwood obtain sensitive and personal information from all guests including names, mailing addresses, passport numbers, account information, and credit card and debit cards numbers. Marriott recently learned of a breach in its database, giving hackers access to personally identifying information for 500 million guests who made reservations at Starwood properties within the last four years. Hackers suspected to be working for foreign intelligence agencies gained access to the database four years ago, but the breach was just now discovered. As a result, individuals' personal identifying information was involuntarily disclosed subjecting them to risk of identity fraud.

The data breach was a result of Starwood's faulty data security system, which Marriott had not altered after its purchase of Starwood. As a result of its alleged negligence, Marriott is facing liability in numerous countries. Notably, the European Union's General Data Protection Regulation could subject Marriott to a fine of up to 4% of its global yearly revenue. Furthermore, Marriott faces class action litigation brought by individuals whose information was leaked.

Causes of Action:

1. Negligence – Duty to exercise reasonable care in safeguarding, securing and protecting PII of Plaintiff (members of class action) from being compromised, lost, stolen, misused, and/or disclosed to unauthorized parties.
    a. Specifically, maintaining and testing their cyber security systems
2. Breach of Implied Contract – Implied contract with Plaintiff, as information was required in order to make a reservation, understanding that Hotel would safeguard that information.
3. State specific allegations outside the scope of the discussion, but important to consider as a defense of this magnitude will require elaborate comparative law analysis and effort.

Alleged Damages:

1. Loss of opportunity to control how their PII is used;
2. Diminution in value of their PII;
3. Compromise, disclosure, and misuse of their PII;
4. Out-of-pocket expenses associated with prevention/detection;
5. Lost opportunity costs from loss of productivity from addressing and attempting to mitigate future consequences of the breach (including researching);
6. Continued risk to the PII; and
7. Future costs in terms of time.

The type of information breached:

Customer PII

National Institute of Standards and Technology (NIST) defines PII as: Personally identifiable information (PII) is any information about an individual that is maintained by an agency, including information that can be used to distinguish or trace an individual's identity, such as name, social security number, date and place of birth, mother's maiden name, or biometric records; and any other information that is linked or linkable to an individual, such as medical, educational, financial, and employment information (based on General Accountability Office and Office of Management and Budget definitions).

International Risk Management Institute (IRMI) defines PII as:

Any information that can be used to uniquely identify, contact, or locate an individual, either alone or in conjunction with other sources, such as their name, Social Security number, driver's license number, date of birth, place of birth, mother's maiden name, and genetic information.

Very Broad definition – Marriott customers' compromised information clearly falls into these definitions as it was passport and credit card information, and all the PII one would need to enter in order to secure a reservation.

CARRYOVER TO REAL ESTATE

At first glance, it is easy for a typical real estate developer to think, this concern is only for Hotels, Restaurants, Vendors, and entities collecting information and running a high volume of payment card transactions. However, there are more facets to consider.

The evidence has revealed hackers had access to Marriott's internal computer systems: Where is Marriott keeping trade secret information? Are they subject to any Non-Disclosure Agreements with third parties? Important information regarding Financial Earnings or public statements prior to their release?

We are only seeing the tip of this iceberg. The Ohio Supreme Court has recognized in *Al Minor & Assoc., Inc. v. Martin*, 117 Ohio St.3d 58 (2008), that the use of a memorized client list can be the basis of a trade secret violation pursuant to Ohio's Uniform Trade Secrets Act ("UTSA"), R.C. 1333.61 et seq.

Aside from the above, another exposure is from your internal operations. Where are employee records housed? Payroll information, Client-Relationship Management Database, Case Management Systems, what is in your email etc.?

Chances are some portion of this in an electronic format. There is also a strong likelihood, this maybe outsourced to a Vendor or some kind SaaS. So it is their problem right?

CONTRACT PROTECTIONS/VULNERABILITIES

Most SaaS and Vendors I have seen are using disclaimers such as:

DISCLAIMERS. VENDOR MAKES NO WARRANTIES, REPRESENTATIONS, OR GUARANTEES IN CONNECTION WITH THE VENDOR SOLUTIONS OR THE SERVICES, WHETHER EXPRESS OR IMPLIED, ARISING BY LAW OR OTHERWISE, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTY OF DESIGN, MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, OR NON-INFRINGEMENT OR ANY IMPLIED WARRANTY ARISING FROM COURSE OF PERFORMANCE, COURSE OF DEALING, OR USAGE OF TRADE. VENDOR AND ITS SUPPLIERS DO NOT WARRANT OR REPRESENT THAT THE VENDOR SOLUTIONS AND/OR THE SERVICES PROVIDED HEREUNDER SHALL BE UNINTERRUPTED OR ERROR-FREE.

VENDOR DOES NOT PROVIDE, AND EXPRESSLY DISCLAIMS ALL WARRANTIES, EXPRESS OR IMPLIED, AND ALL OBLIGATIONS OR LIABILITIES FOR DAMAGES ARISING OUT OF OR IN CONNECTION WITH THE USE, MAINTENANCE OR PERFORMANCE OF THE EQUIPMENT, THIRD PARTY SOFTWARE, THIRD PARTY CONTENT AND THE DELIVERY AND PERFORMANCE OF THE VENDOR SOLUTION IN CONNECTION WITH THE ACCESS BY CUSTOMER TO THE ONLINE SERVICES.

LIMITATIONS OF LIABILITY. AN THE EVENT OF A BREACH BY VENDOR, VENDOR'S AGGREGATE, CUMULATIVE LIABILITY IN CONNECTION WITH ALL AGREEMENTS, THE VENDOR SOLUTIONS AND ALL SERVICES PERFORMED SHALL BE CAPPED AT THE AMOUNT EQUAL TO THE FEES ACTUALLY RECEIVED BY VENDOR FROM CUSTOMER UNDER THE ORDER FROM WHICH THE EVENT CAUSING LIABILITY ARISES IN THE TWELVE (12) MONTHS PRECEDING THE CLAIM. IN NO EVENT SHALL VENDOR BE LIABLE TO CUSTOMER FOR ANY INDIRECT, INCIDENTAL, CONSEQUENTIAL, RELIANCE OR PUNITIVE DAMAGES OR LOST OR IMPUTED PROFITS OR LOST DATA. THE LIMITATIONS AND EXCLUSIONS SET FORTH IN THIS SECTION 14 APPLY TO ALL CLAIMS OR CAUSES OF ACTION ON WHATEVER BASIS AND UNDER WHATEVER THEORY BROUGHT AND IRRESPECTIVE OF WHETHER THE PARTY HAS ADVISED OR HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH CLAIM. ALL CLAIMS AND CAUSES OF ACTION BROUGHT BY CUSTOMER HEREUNDER SHALL BE BROUGHT WITHIN ONE (1) YEAR OF THE TERMINATION OR EXPIRATION HEREOF OR WITHIN SIX MONTHS OF THE DATE THE HARM IS ACTUALLY DISCOVERED, WHICHEVER OCCURS ACTIONS OF DAMAGES OR LIABILITY ARE IMPORTANT ELEMENTS OF THE BASIS OF THE AGREEMENT BETWEEN VENDOR AND CUSTOMER. CUSTOMER UNDERSTANDS AND AGREES THAT VENDOR COULD NOT ECONOMICALLY OFFER THESE TERMS, AND ITS SUBJECT MATTER, TO CUSTOMER WITHOUT THESE LIMITATIONS.

Whether disclaims like this ultimately hold up remains to be seen, however they are enough to make negotiations difficult and expensive and may require going all the way through trial to the DCA before getting resolution.

INSURANCE

As explained, the exposure is out there, cyber liability is every bit as prevalent as General Liability because of the use of technology. So it is imperative that every entity have the right Cyber Liability Insurance. One of the most important issues when looking at the disclaimers and liability limitations from these Third Party Service Providers is understanding how your Insurance will respond to a breach of your material.

Facts are still unfolding with respect to Marriott, but we will see if they had a third party entity handling this information, and the contractual provisions between those two parties. For purposes of this discussion it is helpful to look back at *P.F. Chang's China Bistro, Inc. v. Federal Insurance Company,* 2016 WL 3055111 (9th Cir. 2016).

This case illustrates the exposures when operations, legal, and underwriting are not in synchrony. The Court ultimately held that Federal had no liability for the MasterCard assessments because of the policy's exclusions. In particular, the policy included an exclusion for any loss or expense based on any liability that PF Chang assumed under a contract. In at least three sections of the Master Services Agreement, PF Chang agreed to reimburse or compensate BAMS for fees, fines, penalties, or assessments imposed by MasterCard. Further, the Court said it was unaware of any basis on which PF Chang would be liable to BAMS for the MasterCard assessments other than under the Master Services Agreement. Accordingly, the Court held that the MasterCard assessments fell within the policy's exclusion and were not covered.

CHECKLIST:

Cyber Security is becoming the new GL as far as exposure, and it is becoming the new Accounting in terms of auditing. Most Audits require disclosure of processes regarding cyber security, there are penetration testing firms, all kinds of training services. It can be daunting. The best place to start, in my opinion, is where underwriting starts. Start with the Cyber Liability Application form. Round table it with IT, legal, risk management, HR, and use it as the beginning of the conversation. Just like any Safety and Loss program, GL, Workers' Comp, etc., Cyber must approached with a culture of prevention and checks and balances must be in place to regularly educate staff, update security systems.

COMPUTER & NETWORK SECURITY

Has the Applicant designated a Chief Information Security Officer as respects computer systems and data security?	☐ Yes ☐ No

If 'No', please indicate what position is responsible for computer and data security:	
Does the Applicant publish and distribute written policies and procedures regarding computer and information security to its employees?	☐ Yes ☐ No
Does the Applicant conduct computer and information security training for every employee that has access to computer systems or sensitive data?	☐ Yes ☐ No
Does the Applicant enforce a process for the timely installation of software updates/patches?	☐ Yes ☐ No
If 'Yes', are critical updates/patches installed within thirty (30) days of release?	☐ Yes ☐ No
Does the Applicant restrict user rights on computer systems such that individuals (including third party service providers) have access only to those areas of the network or information that is necessary for them to perform their duties?	☐ Yes ☐ No
Where does the Applicant have a firewall? (check all that apply)	
☐ At network perimeter ☐ Internally within the network to protect sensitive resources	
Which of the following procedures does the Applicant employ to test computer security controls?	
Testing	**Frequency of Testing**
☐ Internal Vulnerability Scanning	☐ Continuously ☐ Monthly ☐ Quarterly
☐ External Vulnerability Scanning against internet-facing IP addresses	☐ Continuously ☐ Monthly ☐ Quarterly
☐ Penetration Testing	☐ Quarterly ☐ Semi-annually ☐ Annually
☐ Other (please describe):	

Does the Applicant store data in any of the following environments, and is such stored data encrypted? (check all that apply)		
☐ Laptops	☐ Encrypted ☐ Not Encrypted	
☐ Portable Media	☐ Encrypted ☐ Not Encrypted	
☐ Back-up Tapes	☐ Encrypted ☐ Not Encrypted	
☐ "at rest" within computer databases	☐ Encrypted ☐ Not Encrypted	
Does the Applicant outsource any of the following? (Check all that apply and please identify the vendor(s)		
☐ Data Center Hosting:	☐ Managed Security:	☐ Alert Log Monitoring:

Please identify your telecommunications carrier:	
Have you established strong alphanumeric passwords for administrative controls of your telecommunications system?	☐ Yes ☐ No
Have you configured your telecommunications system to disable (check all that apply): ☐ Remote system administration and Internet Protocol (IP) access ☐ Dialing via remote system access (DISA)	

PRIOR CLAIMS AND CIRCUMSTANCES

Does the Applicant or other proposed insured (including any director, officer or employee) have knowledge of or information regarding any fact, circumstance, situation, event or transaction which may give rise to a claim, loss or obligation to provide breach notification under the proposed insurance? If yes, please provide details:	☐ Yes ☐ No
During the past five (5) years has the Applicant: a. received any claims or complaints with respect to privacy, breach of information or network security, or, unauthorized disclosure of information?	☐ Yes ☐ No
b. been subject to any government action, investigation or subpoena regarding any alleged violation of a privacy law or regulation?	☐ Yes ☐ No
c. received a complaint or cease and desist demand alleging trademark, copyright, invasion of privacy, or defamation with regard to any content published, displayed or distributed by or on behalf of the Applicant?	☐ Yes ☐ No
d. notified consumers or any other third party of a data breach incident involving the Applicant?	☐ Yes ☐ No
e. experienced an actual or attempted extortion demand with respect to its computer systems?	☐ Yes ☐ No
f. experienced an unexpected outage of a computer network, application or system lasting greater than four (4) hours?	☐ Yes ☐ No
If 'Yes' to any of the above, please provide details regarding such incident(s) or event(s):	

SECTION II
BY: SARA H. JODKA

THE PATCHWORK OF LAWS

Federal laws –

Currently, the federal laws apply on an industry-specific basis, for example:

- Healthcare – HIPAA/HITECH
- Financial – Gramm-Leach-Biley Act; Red Flag Rules
- Contractors – DOD's Defense Federal Acquisition Regulations Supplement (DFARS) rule
- Education – FERPA, COPPA

State laws –

Ohio

- **Data Breach Notification Statute**

Affected residents must be notified in the most expedient time possible but not later than 45 days following its discovery or notification of the breach in the security of the system, subject to the legitimate needs of law enforcement activities and consistent with any measures necessary to determine the scope of the breach, including which residents' personal information was accessed and acquired, and to restore the integrity of the system.

- **S.B. 220**

The Ohio Data Protection Act came into effect November 1, 2018, and it is important for business data holders because it grants them a defense if a data breach occurs and the company can prove it had a CyberSecurity program in place that meets industry-recognized security frameworks.

The Law and Its Affirmative Defense

Unlike most laws, this one is a voluntary law that grants vigilant companies an incentive to meet a "higher level of security" through a number of measures, including: (1) having a written CyberSecurity Program; and (2) implementing strong technical privacy controls in place to protect data. It applies to any business that "accesses, maintains, communicates, or processes personal information [as defined in Ohio Revised Code 1349.19] or restricted information", which is defined as unencrypted information about an individual that can be "used to distinguish or trace the individual's identity."

Specifically, business who seek to take advantage of the defense available through the law, must implement a CyberSecurity program that:

- Is designed to protect the confidentiality and security of personal information;
- Protects against the unauthorized access to and acquisition of personal information that is likely to result in a material risk of fraud or identity theft; and
- Reasonably conforms to one of the following information security, cybersecurity or security assessment frameworks: CIS Critical Security Controls, ISO, IEC, NIST, FedRAMP, and some others.

If the business accepts credit/debit cards, the CyberSecurity programs must also comply with the Payment Card Industry's Data Security Standards (PCI-DSS).

And for businesses that are subject to other industry-specific privacy laws, such as healthcare business that have to comply the Health Insurance Portability and Accountability Act (HIPAA) and the Health Information Technology for Economic and Clinical Health Act (HITECH); and financial institutions that have to comply with the Gramm-Leach-Bliley Act (GLBA); and others, those businesses will have to comply with those laws to use the affirmative defense.

While law requires "reasonable" compliance with one of the listed frameworks, covered entities can tailor the scale and scope of their CyberSecurity to fit own business needs as what would be appropriate, taking into account the following:

- The size and complexity of the business;
- The activities of the business;
- The sensitivity of personal information;
- The cost and availability of tools to improve cybersecurity; and
- The resources available to the business.

The Limits

The law, however, does have its limits. Most notably, it is only applicable to any "tort that alleges or relates to the failure to implement reasonable information security controls, resulting in a data breach", such as negligence and invasion of privacy. This means that the law does not apply to statutory or contract claims. Second, the affirmative defense is only available to claims brought under Ohio law or in Ohio courts.

On September 14, 2018, *Yujian Wang v. Daniel J. Lim, et al*., was filed in the Franklin County Court of Common Pleas as Case Number 18CV007748 in the State of Ohio. The suit alleges that, during a home buying transaction, the title company never received $55,614.98 that the buyer had allegedly wired from his personal savings to his real estate agent. The lawsuit alleges that a hacker, posing as an escrow officer, sent a fraudulent email to the real estate agent asking for the plaintiff's email contact information. After receiving the email information, the hacker, posing as the real estate agent, sent wire instructions for the closing. The plaintiff wired the closing money to the hacker account pursuant to the fraudulent instructions and the money was lost and unavailable for the closing. Plaintiff sued the real estate agent and the real estate agency for negligence.

The case is in the initial stages so there has been no determination on liability, but it demonstrates the type of case that the affirmative defense would be relevant to after the November 1, 2018 effective date of the law. Unfortunately, the affirmative defense is not available to the defendant real estate agency or agency.

The glaring issue then is that businesses that seek to take advantage of the new law will still have to prove their compliance via the appropriate standard of proof to trigger the affirmative defense. This sounds easier said than done, especially when you consider that most of the frameworks identified in the law don't have a standardized process of compliance or come with a certificate or gold star noting that the business is compliant. As such, compliance will be a litigated issue that will impact the cost of litigation defense.

Benefits

Overall, and with anything that encourages business to be more vigilant about their data privacy and cybersecurity, the law is good start. While the actual ability of a business to use the affirmative defense may remain quite low and costly, the benefits of businesses taking stock in their data privacy and cybersecurity to meet the terms of the law is a very good thing. It is definitely a step in the right direction as data breaches can be, and have been, devastating for so many companies with the economic, brand, reputational, and other losses that come along with them.

Differences

The Ohio law is different than the consumer privacy initiatives that have been passed in California and Colorado in that those laws are punitive in nature and penalize businesses for failing to meet specific minimum data security requirements.

Kentucky

- **Data Breach Notification Statute**

Notice must be made in the most expedient time possible and without unreasonable delay, consistent with the legitimate needs of law enforcement and consistent with any measures necessary to determine the scope of the breach and to restore the reasonable integrity of the computerized data system. An information holder that maintains computerized data that includes personally identifiable information that the information holder does not own or license shall notify the owner or licensee of the information of any breach of the security of the data as soon as reasonably practicable following discovery if the personally identifiable information was, or is reasonably believed to have been, acquired by an unauthorized person.

Indiana

- **Data Breach Notification Statute**

<u>Persons/Businesses</u>: A person required to make a disclosure or notification under this chapter shall make the disclosure or notification without unreasonable delay. For purposes of this section, a delay is reasonable if the delay is:

(1) necessary to restore the integrity of the computer system;
(2) necessary to discover the scope of the breach; or

(3) in response to a request from the Attorney General or a law enforcement agency to delay disclosure because disclosure will:
(A) impede a criminal or civil investigation; or
(B) jeopardize national security.

State Agencies: Notice must be made without unreasonable delay; consistent with:
(1) legitimate needs of law enforcement;
(2) any measures necessary to determine the scope of the breach; and
(3) any measures necessary to restore the reasonable integrity of the data system.

An entity that maintains computerized data that includes personal information but that does not own or license the personal information shall notify the owner of the personal information if the entity discovers that personal information was or may have been acquired by an unauthorized person.

A person required to make a disclosure or notification shall make the disclosure or notification as soon as possible after: (1) delay is no longer necessary to restore the integrity of the computer system or to discover the scope of the breach; or (2) the Attorney General or a law enforcement agency notifies the person that delay will no longer impede a criminal or civil investigation or jeopardize national security.

Michigan

- **Data Breach Notification Statute**

A person or agency shall provide any notice required under this section without unreasonable delay. However, a person or agency may delay providing notice if it is necessary to determine the scope of the security breach and restore the reasonable integrity of the database, or if a law enforcement agency determines that providing notice would impede an investigation or jeopardize homeland or national security. An entity that maintains a database that includes data that the entity does not own or license that discovers a breach of the security of the database shall provide a notice to the owner or licensor of the information of the security breach, unless the entity determines that the security breach has not or is not likely to cause substantial loss or injury to, or result in identity theft with respect to one or more residents of Michigan.

International laws –

GDPR

The General Data Protection Regulation (GDPR) went into effect on 25 May 2018 and introduced substantial changes to current European privacy law, although in application, it had even broader reach.

Increased Jurisdictional Scope

One of the most significant changes under the GDPR is its enhanced territorial scope. The new law applies to organizations holding or using data about individuals located in the EU, even in the absence of any physical EU presence, where organizations:

- offer goods or services within the EEA (e.g. by having EU language versions of a website); or
- monitor the on-line behavior of individuals in the EU (e.g. by using cookie technology).

If these extra-jurisdictional provisions apply, non-EU organizations have to comply with the entirety of the GDPR or suffer the enhanced penalties regime (see below). Full compliance with the GDPR's 99 Articles will require, among other things, rapid reporting of data breaches to EU privacy regulators, compliance with various rights granted to individuals including the individual's right to have their data deleted and the maintenance of detailed internal records of data processing operations.

While the GDPR is the most significant change to European data privacy and security in over 20 years, and that is certainly true, it is also the most significant change to US data privacy security since HIPAA (as it impacted the healthcare industry) as many US-based companies will fall within the GDPR's reach, one way or another. The GDPR reaches into US-based companies because the GDPR is designed to protect the "personal data" of individuals. Despite what you might have read in other sources, the GDPR does not say EU "residents" or EU "citizens", it says it applies to the processing of "personal data of data subjects" but controllers and processors who are in the EU, but also to "processing activities" related to: (1) offering goods or services; or (2) monitoring data subject behavior that takes places in the EU. See GDPR Article 3(2).

The GDPR replaces the 1995 EU Data Protection Directive which generally did not regulate businesses based outside the EU. However, now even if a US-based business has no employees or offices within the boundaries of the EU, the GDPR may still apply.

Privacy and Personal Data: EU v. US

Stepping back for a second, to understand the GDPR, it is important to understand that most of the world views privacy very differently than the US. Where many Americans put a lot of their personal information online via social media right down to what they ate for breakfast, privacy is a very tightly-held right in other parts of the globe and the definition of privacy is far more robust.

For example, where "personal data" is typically defined by US breach notification laws as an individual's name accompanied by some other type of identifying information, such as a social security number or financial account information, "personal data" under the GDPR goes much further and includes, "information related to an identified or identifiable natural person." This means that, if you can use any piece of information for learn or otherwise identify a natural person, the information is "personal data" under the GDPR, and the processing of that data is protected by the GDPR. This type of information includes an individual's name, ID number, location data, online identifier or other factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that person. It also includes, religion, trade union association, ethnicity, marital status, IP addresses, cookie strings, social media posts, online contacts, and mobile device IDs.

Controller v. Processor

Stepping back for a second to understand the GDPR, it is important to understand that most of the world views privacy very differently than the US. Where many Americans put a lot of their personal information online via social media right down to what they ate for breakfast, privacy is a very tightly-held right in other parts of the globe, and the definition of privacy is far more robust.

For example, where "personal data" is typically defined by US breach notification laws as an individual's name accompanied by some other type of identifying information, such as a social security number or financial account information, "personal data" under the GDPR goes much further and includes, "information related to an identified or identifiable natural person." This means that, if you can use any piece of information for learn or otherwise identify a natural person, the information is "personal data" under the GDPR, and the processing of that data is protected by the GDPR. This type of information includes an individual's name, ID number, location data, online identifier or other factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that person. It also includes, religion, trade union association, ethnicity, marital status, IP addresses, cookie strings, social media posts, online contacts, and mobile device IDs.

The concepts of "controller", "processor" and "processing of personal data" are part of the new lexicon that US-based companies falling under the GDPR are going to have to get familiar because they are not terms that have much impact in the US, until now.

Simply put, "processing" personal data is basically collecting, recording, gathering, organizing, storing, altering, retrieving, using, disclosing, other otherwise making available personal data by electronic means.

A “controller” is the entity that determines what to do with the personal data. Take for example, a company collects personal information from its customers in order to sell them products. In turn, the company provides that data to its shipping vendors and payment vendors to ship the products to the customers and to bill and collect payment from the customers. The company/seller is the controller, and the shipping company and the payment company are processors.

With this example, the scope of the GDPR to US-based companies also becomes a little clearer as you can start to see where US-based companies would fall somewhere in that controller processor chain as far as they are selling to customers located in the EU.

The GDPR even applies if no financial transaction occurs if the US company sells or markets products via the Internet to EU residents and accepts the currency of an EU country, has a domain suffix for an EU country, offers shipping services to an EU country, provides translation in the language of an EU country, markets in the language of an EU country, etc.

The GDPR also applies to employee/HR data to the extent the individual employee is a data subject with rights in the EU.

As such, US-based companies with no physical presence in the EU, but in industries such as e-commerce, logistics, software services, travel and hospitality with business in the EU, etc., and/or with employees working or residing in the EU should be well in the process of ensuring they are GDPR compliant as should US-based companies with a strong Internet presence.

At a minimum, what should companies know?

At a bare minimum, you should understand that if a company you work with is asking you to revise an agreement, sign off on a verification, or something similar, it might be related to their obligations under the GDPR and, in turn, yours.

One of the keys to the GDPR is that data subjects must be fully informed about what is happening to their data, why it is being collected, how it will be used, who will be processing it, where will it be transferred, how they can erase it, how they can protect it, how they can stop its processing, etc. The bulk of the consent and notification responsibility falls on the controller, but the processor and the controller have to work together to ensure the data subject’s rights are protected and this will happens in two separate but distinct steps:

The first step is in the overall physical compliance process, which takes the most time as it requires reviewing data collection and processing; ensuring there is a legal right to have the data and process it; gaining a fundamental understanding of what is going on with the data and where it is going; building security protocols around the data; etc.

Controllers

Controllers specifically must, at a minimum:

1. Review data processing activities and conduct an Impact Assessment.
2. Identify their data processing activities for which it is a controller and ensure it understands its responsibilities.
3. Ensure that, in respect of each processing activity for which it is a controller, it has implemented appropriate technical and organizational measures to ensure compliance with the GDPR; and ensure it has appropriate processes and templates in place for identifying, reviewing and (and to the extent required) promptly reporting data breaches.

Processors

Processors must, at a minimum:

1. Review all data processing activities.
2. Ensure there is a lawful basis for each processing activity (or that there is consent or that an exemption or derogation applies).
3. Where consent is the basis for processing, review existing mechanisms for obtaining consent, to ensure they meet GDPR.
4. Where a legitimate interest is the basis for processing, maintain records of the organization's assessment of that legitimate interest, to show the organization properly considered the rights of the data subjects.
5. Update privacy policies.
6. Train employees who process personal data to quickly recognize and appropriately respond to requests from data subjects to exercise their rights.

The second step is in contracting between the controller and processor to ensure their contracts meet all the legal specifications of the GDPR. The GDPR outlines a number of contractual requirements between controllers and processors including: identifying the subject matter and duration of the processing; identifying the nature and purpose of the processing; structuring the obligations and rights of the controller; acting only upon the written instructions of the controller; ensuring those processing data are doing it under written confidentiality agreement; assist the controller in meeting breach notification requirements.

Unlike US breach notification laws that allow more time to notify the appropriate individuals and authorities of a data breach, the GDPR requires notification be made within 72 hours of a breach.

Enhanced Penalties

One of the more publicized changes under the GDPR is its enhanced penalties. Organizations that commit a serious breach of its provisions face potential fines up to the greater of EUR 20m or 4 % of the worldwide annual revenue.

Laws coming soon –

- **California Consumer Protection Act**

Just as U.S. companies were just settling into the idea of the EU's General Data Protection Act (GDPR), California just passed the California Consumer Privacy Act of 2018, Cal. Civ. Code §§ 1798.100 *et seq.* (CCPA), which will require U.S. companies to implement a number of similar privacy initiatives, which will afford California residents unparalleled (in the United States) data privacy rights. The law takes effect on January 1, 2020, and the following summarizes the law, including who it applies to and how, and offers a step-by-step guide to compliance.

<u>What Businesses Must Comply with the CCPA?</u>

Subject to a number of exceptions, discussed below, the CCPA covers every "business" that collect and sells consumer "personal information" or discloses personal data for a business purpose.

Going through the relevant definitions, a "business" is a for-profit legal entity doing business in California that collects personal information regarding California residents. Following well-established jurisprudence, the scope of "doing business" in California applies to companies that sell goods or services to California residents *even if the business is not physically located in California*. Its application beyond U.S. borders could significantly expand the impact of the legislation.

Not all business qualify. To fall within the scope of the CCPA, the business must also meet *one* of the additional *three* criteria:

- Have $25 million or more in annual revenue; or
- Possess the personal data of more than 50,000 "consumers, households, or devices" or
- Earn more than half of its annual revenue selling consumers' personal data.

As for what constitutes "personal information", that term is defined broadly as "information that identifies, relates to, describes, is capable of being associated with, or could reasonable be linked, directly or indirectly, with a particular California resident or household. The definition of "personal information" includes:

- Personal identifiers, such as a real name, alias, postal address, unique personal identifier, IP address, email address, account name, social security number, driver's license number, passport number, or other similar identifiers;
- Commercial information, including records of personal property, products or services purchased, obtained, or considered, or other purchasing or consuming histories or tendencies;
- Internet or other electronic network activity information, including, but not limited to, browsing history, search history, and information regarding a California resident's interaction with an internet web site, application, or advertisement;
- Geolocation data;
- Biometric information;
- Audio, electronic, visual, thermal, olfactory, or similar information;
- Professional or employment-related information; and
- Education information.

A "consumer" is a natural person (so not a legal entity such as a corporate) who is a California resident, which includes every individual who is in the state for other than a temporary or transitory purpose, or every individual who is domiciled in the state who is outside the state for a temporary or transitory purpose. The definition is quite broad, which means it appears to cover California residents *while they are traveling in other states*.

Exclusions

The CCPA's obligations do not restrict a business' ability to collect or sell a consumer's personal information if every aspect of that commercial conduct takes place completely outside of California. In other words, if the business collected the consumer's personal information while the consumer was outside California, no part of the sale of the consumer's personal information occurred in California, and no personal information collected while the consumer was in California is sold.

The CCPA also does not apply to information that is subject to other federal regulation, including, the Health Insurance Portability and Accountability Act (HIPAA); the Graham-Leach Bliley Act (GLBA); the Fair Credit Reporting Act (FCRA); or the Drivers' Privacy Protection Act (DPPA), The CCPA, however, will apply to entities covered by these laws to the extent they collect and process other personal information about consumers.

What Rights the CCPA Afforded Consumers?

The CCPA will provide consumers with new rights, including a right to transparency about data collection, a right to be forgotten, and a right to opt out of having their data sold (opt in for minors).

While the list of rights may seem largely identical to the list of rights guaranteed to EU data subject under the GDPR, there are a number of significant difference, one being that the GDPR is structured as an opt-out mechanism as opposed to the GDPR's confusing opt-in mechanism.

The opt-out structure of the CCPA grants consumers the following rights and does the following:

The right to know whether their personal information is being collected about them
• Requires businesses to make disclosures to consumers about any personal information collected and the purposes for which the personal information is used.

The <u>right</u> <u>to</u> <u>request</u> the specific categories of information a business collects upon verifiable request
• Grants consumers a right to request that a business disclose the categories and specific pieces of personal information that the business collects about them, the categories of sources from which that information is collected, the business purposes for collecting or selling the information, and the categories of third parties with which the information is shared.
The right to know <u>what</u> personal information is being collected about them
• Requires businesses to make disclosures to consumers about any personal information collected and the purposes for which the personal information is used. • Grants consumers a right to request that a business disclose the categories and specific pieces of personal information that the business collects about them, the categories of sources from which that information is collected, the business purposes for collecting or selling the information, and the categories of third parties with which the information is shared.
The right to <u>say</u> "<u>no</u>" to the sale of personal information
• Authorizes consumers to opt out of the sale of personal information by a business and prohibits the business from discriminating against the consumer for exercising this right, including by charging the consumer who opts out a different price or providing the consumer a different quality of goods or services, except if the difference is reasonably related to value provided by the consumer's data. • Prohibits a business from selling the personal information of a consumer under 16 years of age, unless affirmatively authorized. • ***The definition of the word "sell" for purposes of the CCPA is broad and includes, "selling, renting, releasing, disclosing, disseminating, making available, transferring, or otherwise communicating orally, in writing, or by electronic or other means, a consumer's personal information by the business to another business or third party for monetary or valuable consideration*."
The right to delete their personal information
• Grants consumers the right to request deletion of personal information and would require the business to delete personal information upon receipt of a verified request.
The right to <u>equal</u> <u>service</u> <u>and</u> <u>price</u>, even if they exercise their privacy rights
• Authorizes businesses to offer financial incentives for collection of personal information

<u>Step-By-Step Compliance</u>

For those companies that had to comply with the GDPR, the CCPA should be a piece of cake. For those that did not, well, those companies can learn a lot from those still recovering (or still suffering) from GDPR heartburn. Below are some key steps to CCPA compliance:

Step 1: Update Privacy Notices and Policies

With *all* the “We’ve updated our Privacy Policy” (GDPR-compliance) emails received in May 2018, it is probably reasonable to expect another wave, this time CCPA compliant, in December 2019.

The California Online Privacy Protection Act of 2003 already requires companies who process the personal information of California consumers through commercial websites to post a privacy notice, and companies that had to be GPDR compliance added additional information to those privacy notices in early 2018.

The CCPA will require that “at or before the point of collection” covered companies provide notice to consumers informing them of the categories of personal information the company collects and what purpose the information is used by the company.

The notice must also explicitly set forth the categories of personal information that are collected, disclosed, or sold (*see* broad definition discussed above), and consumers have a new right to opt-out of having their information sold.

Companies will also need to update their privacy policies to include a description of the other new consumer rights afforded by the CCPA (*see* chart above).

As many companies had to determine when becoming GDPR compliant, prior to making the legally-required policy updates, companies will need to determine if they will maintain one privacy notice for California residents and one other consumers, or have one universal policy.

Step 2: Update Data Inventories, Business Processes, and Data Strategies

Companies will also have to maintain a data inventory, which is essentially a database to track their data processing activities, including the business processes, third parties, products, devices, and applications that process consumer personal data.

Companies that had to become GDPR compliant will have to add a few columns to their data inventories including, a column:

(1) identifying if the data use includes the “sale” of information;
(2) identifying what categories of personal information are transferred to third parties;
(3) identifying if any categories of personal information are covered by HIPAA, the FCRA, HIPAA, or another law that would exempt the data from the CCPA’s scope; and
(4) identifying if the data was collected more than 12 months ago and, thus, potentially exempt.

The database will also have to be kept up to date and be able to track all consumer right requests, such as tracking a verified request for information.

Step 3: Implement Protocols to Ensure Consumer Rights

As set forth more summarily above, the CCPA guarantees a number of consumer rights that businesses will need to take steps to ensure.

Right to Notice	While it is not exactly a granted right, at the time or before a business collects personal information from a consumer, the consumer must be properly notified which categories of information are being collected and the purposes for which the information is being used.
Right of Access / Right to Request	Upon verifiable request, the business must take steps to disclose and deliver, free of charge to the consumer, the personal information, which may be delivered by mail of electronically. If provided electronically, it must be provided in a portable and, to the extent technically feasible, in a readily usable format that allows the consumer to transmit the personal information to another entity without issue. A business may provide personal information to a consumer at any time, but does not have to provide it to a consumer more than twice in a 12-month period. (*Note*: This does not require a business to retain person information that is collected for a single one-time transaction if the information is not sold or retained by the business or to re-identify or otherwise link information that is not maintained in a manner that would be considered personal information.)
Right to Know	The consumer has the right to request that a business that collects personal information disclose the following: (1) the categories of personal information collected; (2) the sources from which the information was collected; (3) the business or commercial purpose for collecting or selling the information; (4) categories of third parties with whom the business shares the information; (5) the specific pieces of personal information the business collected about the consumer. (*Note*: this does not require a business to retain person information that is collected for a single one-time transaction if the information is not sold or retained by the business or to re-identify or otherwise link information that is not maintained in a manner that would be considered personal information.)
Right to Delete	The consumer has the right to request, upon verifiable request, that a business delete any personal information about the consumer the business has collected. Upon receipt of such request, the business must delete the information and direct any service providers to delete the information from its records as well unless the business or service provider needs the information to: (1) compute the transaction for which the personal information was collected, provide a good or service requested by the consumer, or reasonably anticipated within the context of a business's ongoing business relationship with the consumer, or otherwise perform a contract between the business and the consumer; (2) detect security incidents; protect against malicious, deceptive, fraudulent, or illegal activity; or prosecute those responsible for that activity; (3) debug to identify and repair errors existing intended functionality; (4) exercise free speech, ensure the right of another consumer to exercise his/her right of free speech, or exercise another right provided for by law; (5) comply with the California Electronic Communications Privacy Act; (6) engage in public or

	peer-received scientific, historical, or statistical research in the public interest; (7) to enable solely internal uses that are reasonably aligned with the expectations of the consumer based on the consumer's relationship with the business; (8) comply with a legal obligation; (9) otherwise use the consumer's personal information, internally, in a lawful manner that is compatible with the context in which the consumer provided the information.
Right to Opt Out	The consumer has the right to opt out of the sale of personal information by a business. Businesses must make available, in a form reasonably accessible to consumers, a clear and conspicuous link to the homepage, titled "<u>Do Not Sell My Personal Information</u>" that enable a consumer to opt-out of the sale of the consumer's personal information. The business must wait at least 12 months before requesting to sell the personal information of any consumer who has opted out. If the consumer's information is sole, the consumer has additional rights and can request a business that sells or discloses the information for a business purpose, disclose to the consumer: (1) the categories of personal information the business collected about the consumer; (2) the categories of information the business sold about the consumer and the categories of third parties to whom the information was sold, by category or categories of information for each third part to whom the information was sol; and (3) the categories of information the business disclosed about the consumer for a business purpose. With this, a third party is prohibited from selling information about a consumer that has been sold to the third party by a business <u>unless</u> the consumer has received explicit notice and is provided the opportunity to opt out.
Right to Notification of Financial Incentive	A business may charge a consumer a different price or rate, or from providing a different level or quality of goods or services to the consumer, if that difference is reasonably related to the value provided to the consumer by the consumer's data. Businesses may offer financial incentives, including payments to consumers as compensation, for the collection of information, the sale of personal information, or the deletion of information. A business may also offer a different price, rate, level, or quality of goods or service to the consumer if that price or difference is directly related to the value provided to the consumer by the consumer's data. If a business offers financial incentives must notify customers of them. A business may enter a consumer into a financial incentive program only if the consumer gives the business prior opt-in consent that clearly describes the material terms of the financial incentive program, and which may be revoked by the consumer at any time.
Right Not to Be Discriminated Against	Businesses are prohibited from discriminating against a consumer for exercising any of the consumer's rights, including by: (A) denying goods or services to the consumer; (B) charging different prices or rates for goods or services, including the use of discounts or other benefits or imposing penalties; (C) providing a different level or quality of goods or service to the consumer; or (D)

	suggesting that the consumer will receive a different price or rate for goods or services or a different level or quality of goods or service. The prohibition on discrimination, however, does not prohibit a business from charging a consumer a different price or rate, or from providing a different level or quality of goods or services to the consumer, if that difference is reasonably related to the value provided to the consumer by the consumer's data. Businesses may offer financial incentives, including payments to consumers as compensation, for the collection of information, the sale of personal information, or the deletion of information. A business may also offer a different price, rate, level, or quality of goods or service to the consumer if that price or difference is directly related to the value provided to the consumer by the consumer's data. If a business offers financial incentives must notify customers of them. A business may enter a consumer into a financial incentive program only if the consumer gives the business prior opt-in consent that clearly describes the material terms of the financial incentive program, and which may be revoked by the consumer at any time.

To ensure consumers can exercise their rights to: (1) request information about what information the business collects and what it does with the information; (2) request that the business delete any personal information collected; and (3) not be discriminated against, **the business must make available to consumers at least two designated methods for submitting requests for information, including, at a minimum, a toll-free telephone number and, if the business has a Website, a Website address**.

The business also must ensure it has protocols in place to respond to such requests free and within 45 days of receiving a verifiable request.

This information must be disclosed in the business's online privacy policy or in any California-specific description of consumers' privacy rights, and the information must be updated at least once every 12 months.

This is what a roll-out may look like in application:

1. Ensure data inventory is up-to-date and contains all required information, which will include defining the businesses record systems and designated records sets to be used as the authoritative data sets for all CCPA purposes;
2. Update all relevant policies, including any California-specific descriptions concerning consumers' privacy rights;
3. Update policies to provide for data subject requests, including a toll-free number of Website address;
4. Determine a process for documenting consumer requests, which must include a protocol for authenticating requests, timely responding to requests, effected a "stop-the-sale-of-information" order; and denying improper or untimely requests;
5. Training employees who handling consumer requests on the businesses' relevant privacy policies and procedures to ensure timely processing, responding, monitoring, and updating of the data inventory;
6. Ensuring data inventory processes are kept up to date as new consumer information is collected and deleted;
7. Ensuring consumers who opted out of the sale of their information are not asked to re-consent before 12 months of their opting out has passed;
8. Update all relevant privacy policies once every 12 months.

Step 4: Make Security Updates

The CCPA requires covered businesses protect personal data with "reasonable" security. In practice, this standard has led companies to take a risk-based approach toward addressing threats to the confidentiality, integrity, and availability of personal data. They assess the threats to data, rank the risks of the detected vulnerabilities, and address the high-risk gaps first. For not a few corporations, the cost of addressing high-risk gaps is staggering, and some accept the risk of not mitigating some medium-risk gaps.

Step 5: Update Third-Party Processor Agreements

To comply with the CCPA, businesses that have other companies process their data will need to update their third party contracts including inserting standard-contractual clause language; requiring vendor data inventories; using due diligence questionnaires; providing records of processing; requiring the syncing of consumer response processes; requiring onsite assessment and auditing; and requiring mapping of the specific data elements shared with each third party, including designating those transfer that qualify as "selling".

For those third-party that paid for information, they will need to additionally design processes to accommodate consumer requests to opt out of selling and provide for the deletion of that data.

Step 6: Training

The CCPA requires that employees handling consumer inquiries be informed of *all* of its requirements. Due to the penalties involved (*see* below) this training should be the minimum and additional employee training is recommended.

Penalties

The CCPA will generally be enforced by the Attorney General, but it does provide for a private right of action in instances where there is certain unauthorized access and exfiltration, theft, or disclosure of non-encrypted or non-redacted personal information.

If "non-encrypted or non-redacted" consumer information is compromised because of a failure of reasonable security, a consumer may bring a legal action for statutory damages ranging from $100 to $750 per violation or actual damages, whichever is greater.

All other penalties are driven by the Attorney General. The AG may target the reasonability of a company's security measures, but the AG is also responsible for pursuing statutory penalties and those penalties can go up to $7,500 per violation.

SECTION III
BY: FRANCES FLORIANO GOINS

TECHNICAL SAFEGUARDS

What are technical safeguards?

Technical safeguards are the technology and the policies and procedures for its use that protect electronic information and control access to it. There are a number of technical frameworks, constructs, or guidelines that may be applicable to different entities. Such frameworks include, but are not limited to:

- National Institute of Standards and Technology Cybersecurity Framework (NIST) – further described below
- ISO/IEC 27000 – a family of information security standards published by the International Organization for Standardization (ISO) and by the International Electrotechnical Commission (IEC)
- IEC 62443 – a framework created by the IEC Technical Committee 65 for operational technology found in industrial and critical infrastructure, including but not restricted to power utilities, water management systems, healthcare and transport systems, that can be applied across many technical areas
- CIS Controls and Benchmarks – the Center for Internet Security (CIS) is a nonprofit organization developed to identify, develop, validate, promote, and sustain best practice solutions for cyber defense and provide global standards for internet security
- FedRAMP – the Federal Risk and Authorization Management Program (FedRAMP) is an assessment and authorization process for U.S. federal agencies, directed by the Office of Management and Budget, to ensure that appropriate security measures are in place for cloud computing products and services

None of these frameworks provide "check lists" or specific provisions that can be implemented by all entities, however, so each entity must design data protection policies and procedures that fit its business and the types of data it collects. Since all businesses are different, it is necessary to first examine the types of data the business collects or maintains, determine the reasons why such data is needed by the business, how it is used, and who needs to have access to it for legitimate purposes, before effective protective policies and procedures can be designed and implemented.

Note that if credit card data is being stored by the entity, the technical safeguards must also comply with the Payment Card Industry's Data Security Standards (PCI-DSS).

National Institute of Standards and Technology Cybersecurity Framework

The most well-known cyber security framework in the U.S. is the National Institute of Standards and Technology Cybersecurity Framework. This framework is a good starting place for most entities and businesses seeking to assess and implement better cybersecurity, since it is based on current recognized "best practice" standards, guidelines, and practices to better understand, manage, and reduce cybersecurity risk.

The framework has five components: Identify, Protect, Detect, Respond, and Recover. When implemented, these components provide a high-level, strategic view of the lifecycle of an organization's management of cybersecurity risk.

Identify – Develop the organizational understanding to manage cybersecurity risk to systems, assets, data, and capabilities.

> Examples include: Asset Management; Business Environment; Governance; Risk Assessment; and Risk Management Strategy.

Protect – Develop and implement the appropriate safeguards to ensure delivery of critical infrastructure services.

Examples include: Access Control; Awareness and Training; Data Security; Information Protection Processes and Procedures; Maintenance; and Protective Technology.

Detect – Develop and implement the appropriate activities to identify the occurrence of a cybersecurity event.

Examples include: Anomalies and Events; Security Continuous Monitoring; and Detection Processes.

Respond – Develop and implement the appropriate activities to take action regarding a detected cybersecurity event.

Examples include: Response Planning; Communications; Analysis; Mitigation; and Improvements.

Recover – Develop and implement the appropriate activities to maintain plans for resilience and to restore any capabilities or services that were impaired due to a cybersecurity event.

Examples include: Recovery Planning; Improvements; and Communications.

Is there such thing as cybersecurity "compliance"?

There is no real standard for compliance when it comes to cybersecurity. The goal is to reduce risk. In addition to technical safeguards, there are a number of relatively inexpensive measures businesses can take to reduce cyber risk.

Implementing safeguards to reduce cyber risk

Develop a wire policy—A business email compromise (BEC) is an attack that deceptively convinces businesses to wire funds to a criminal's bank account by pretending to be business counterparties, such as vendors or real estate sellers. Alternatively, criminals may send an email from a spoofed account that appears to be from someone within the business such as the CEO, or a trusted party like an attorney or escrow agent, usually asking that funds be wired "immediately," to the criminal's account. One of the easiest and most effective ways to substantially reduce the risk of becoming the victim of a BEC scam is to implement a two-step authentication policy requiring confirmation of funds transfer requests by secure telephone or a secondary sign-off by authorized company personnel. Companies should never wire funds based solely on an email or seek verification by responding to an email request.

Training—Most hackers continue to rely on phishing - using deceptive emails to induce people to click on links or open attachments that load malware onto the computer - to execute their attacks. Employee training can be an effective tool for lowering the risk of becoming the victim of such an attack. Also, simply requiring employees to change system passwords often and regularly can deter many attempted system breaches.

Restrict system access – Segment your network on a "need to access" basis. This practice limits accidental transfer of critical data and prevents hackers from using one point of entry to move a virus or malware through your entire system.

Encryption – Encrypt critical data and communications.

Negotiating information security provisions with counterparties to real estate agreements—Sometimes emails that include new wire instructions from criminals are from valid email addresses, not spoofed email addresses. To protect the entity that will be wiring funds, it is prudent to incorporate contract provisions requiring the counterparties to maintain reasonable security controls and giving the entity the right to audit counterparties' security. These provisions may not only reduce risk, but if the counterparty is hacked, there may be a potential cause of action for breach of contract for any damages arising from that hack.

Backing up systems—Ransomware attacks can tie up an entity's data or freeze its systems to coerce payment to the criminal hackers. The threat of ransom is much less significant for businesses that regularly and adequately back up their systems. Having backups of data and the ability to quickly restore the data makes it easier to ignore ransom threats following an attack.

Negotiate cloud computing agreements—Many organizations use cloud providers to store sensitive information about real estate projects and employees. Businesses should attempt to negotiate additional protections in cloud computing agreements instead of accepting the vendor's standard terms and conditions. By focusing on adding information security standards and notification requirements, as well as additional indemnification and limits of liability that provide meaningful remedies in the event of a data breach affecting the cloud provider, a business can better protect itself from such contingencies.

Cyber liability insurance—There is no such thing as perfect security, and, as discussed above, cyber liability insurance can be an important way to mitigate risk. There is a wide disparity in coverage in cyber liability insurance policies, so it is important to ensure that a policy covers the expected risks for the particular business, including potentially BEC scams, ransomware threats (and payment of ransoms), contract claims, and business interruption.

LEGAL, ETHICAL, AND OTHER OBLIGATIONS

ABA Opinion

The American Bar Association Standing Committee on Ethics and Professional Responsibility has published guidance for attorneys who store client and other sensitive data electronically, as well as guidance for attorneys who experience a data breach.

ABA Formal Opinion 477 (May 11, 2017)

A lawyer generally may transmit information relating to the representation of a client over the internet without violating the Model Rules of Professional Conduct where the lawyer has made "reasonable efforts" to prevent inadvertent or unauthorized access. However, a lawyer may be required to take special security precautions to protect against the inadvertent or unauthorized disclosure of client information when required by an agreement with the client or by law, or when the nature of the information requires a higher degree of security.

"Reasonable efforts" require a fact-based analysis –

- Understand the nature of the threat
- Understand how client confidential information is transmitted and where it is stored
- Understand and use reasonable electronic security measures
- Determine how electronic communications about client matters should be protected
- Label client confidential information
- Train lawyers and non-lawyer assistants in technology and information security
- Conduct due diligence on vendors providing communication technology

ABA Formal Opinion 483 (October 17, 2018)

A second ABA ethics opinion describes a lawyer's obligations under the Model Rules of Professional Conduct after an electronic data breach or cyberattack that compromises client data. Formal Opinion 483 states that an ethical violation may occur when a lawyer does not undertake "reasonable efforts" to avoid data loss or to detect cyber-intrusion and that lack of reasonable effort is the cause of the breach.

The reasonableness standard does not include requirements for specific security measures (such as firewalls, passwords, or the like) and instead adopts a practical, fact-specific approach to attorneys' security obligations that requires a "process" to assess risks, identify and implement appropriate security measures responsive to those risks, verify that the measures are effectively implemented, and ensure that they are continually updated in response to new developments.

The following are some of the factors to consider when determining whether reasonable efforts were made to prevent a breach:

- Sensitivity of the information
- Likelihood of disclosure if additional safeguards are not employed
- Cost of employing additional safeguards
- Difficulty of implementing the safeguards
- Extent to which the safeguards adversely affect the lawyer’s ability to represent clients.

<u>ON THE HORIZON</u>

The Internet of Things (IoT)

The IoT is the network of devices that connect via the Internet, including desktops, laptops, smartphones, and tablets, as well as a broad range of products containing electronics, sensors, actuators, and software built into everything from cars and home appliances to buildings. While this technology provides real estate and other businesses with important new ways to collect and store data, it also creates additional risks. Smartphones and laptops, for instance, may be more vulnerable to hacking, particularly if they are not properly secured and password protected, and can provide criminals with direct access to otherwise secure systems if data is not properly encrypted and walled off. Cybersecurity programs for IoT support the development and application of standards, guidelines, and related tools to improve the cybersecurity of connected devices and the environments in which they are deployed.

In 2015, the Federal Trade Commission (FTC) issued recommendations to protect data collection, storage, and processing, including suggesting that data owners should have a choice as to what data they share with IoT companies. The FTC did not make its recommendations mandatory. (https://www.ftc.gov/news-events/press-releases/2015/01/ftc-reprt-internet-things-urges-companies-adopt-best-practices) As the IoT develops, expect more governmental regulation in the future.

Smart Homes/Buildings

Smart buildings seem to be a necessity moving forward, leveraging building data to optimize operations and lower facility costs, while increasing safety and sustainability. Smart buildings adapt to occupancy needs in real time, while optimizing energy usage as much as possible. They often connect internal systems – HVAC controls, data networks, power management, *etc*. – with external networks to more efficiently monitor and manage building operations.

Connectivity and automation create entry points for cyber-attacks, with potential safety, continuity, quality, and privacy impact. For instance, the massive breach at Target in 2015 that exposed hundreds of thousands of consumer credit records to potential abuse resulted from an intrusion through a company HVAC vendor that had not been walled-off, and thus provided back-door access to Targets’ other systems. Ransomware can target any physical devices that are internet-enabled, not just personal computers and servers. The number of devices that are internet-enabled is increasing, and this interconnectivity comes with an increased risk that hackers can take control of entire systems or make the systems unworkable.

Interconnected Apps

With the IoT expanding daily, technology providers are developing more and more applications and products that are able to share data with each other. This creates a concern because as more people start using connected devices through such applications, the amount of data businesses take in will grow exponentially. Part of the reason why a device or application that shares data is so attractive to consumers is precisely because it can network with other devices or applications in a wide range of ways. However, it is that networking ability that makes such interconnected devices vulnerable. If a hacker is able to use a connection to gain access to an external device like a smartphone with emails, or a banking app with personal data, then other business data may be at risk as well.