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LEED and the Retail Industry

What is LEED? LEED is a trademarked acronym of the United States Green Building Council and stands for Leadership in Energy and Environmental Design. The United States Green Building Council (USGBC) is not a governmental organization but a non-profit organization that promotes energy efficiency and conservation for residential, commercial and industrial buildings. LEED was developed by the USGBC as an award program similar to the EPA's Energy Star program. However, LEED has made its way into being a minimum threshold standard for designing and building many, if not most, public building in the United States. There are currently 200 jurisdictions in the United States that either require or encourage developers to meet or exceed LEED standards in public buildings. Further, municipalities such as San Francisco and Los Angeles are considering adopting LEED standards as a threshold for virtually all new buildings; the town of Babylon, New York, has already adopted LEED standards for all new buildings; and the city of Chicago provides expedited building permits for LEED projects.

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The first major hurdle for the retail industry is that LEED standards do not exist for retail development. Instead, any project that desires LEED certification must fit itself into one of the existing commercial LEED standards (new construction, existing building, core and shell, or commercial interiors). The USGBC, with input from a limited number of retailers, is expected to publish the LEED retail standard in the fall of 2008. At this point, it is unclear whether the standard will be flexible enough to account for the various types of retail development—indoor mall, big box, open air center, mixed use.

Some retailers have attempted to meet LEED standards with varying results. The best results and least additional costs occur where existing local requirements already mandate many LEED requirements. In addition, for redevelopment, incorporating additional LEED requirements to attain certification can be economically viable because LEED accounts for the reuse of on-site materials. For example, in a Modesto, California, development which redeveloped an abandoned Safeway shopping center, over half of the LEED standards needed to achieve Silver certification were part of the initial project parameters. However, for many retailers, achieving LEED certification has been abandoned in favor of incorporating green attributes that provide real economic returns. At the same time, retailers have offered their help to the USGBC in developing workable retail standards.

State and local governments will adopt LEED standards for retail development, the question is only when. The response of retailers remains to be seen.

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Exactions in Connecticut

In many states across the United States, before governmental approvals are given to subdivide previously undeveloped property or to develop and redevelop property, the developer must pay or satisfy certain governmental requirements called "exactions." Exactions include easements for drainage, access and other purposes given by the developer to the municipality for a municipal purpose, a contribution for infrastructure or other costs that will be incurred by the municipality and

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the public at large as a result of the development of the property by the developer, or an open space contribution or greenbelt dedication that will assure that a certain portion of the property will never be developed in the future but will be green space.

In Connecticut, exactions are limited to those allowed by Section 8-25 of the Connecticut General Statutes, which relates to the subdivision of land. The statute sets out the parameters of allowable municipal regulations, which cannot exceed the authority set forth in Section 8-25.

Section 8-25 allows a local land use commission to enact regulations requiring "open spaces, parks and playgrounds when, and in places, deemed proper by the planning commission, which open spaces, parks and playgrounds shall be shown on the subdivision plan. Such regulations may, with the approval of the commission, authorize the applicant to pay a fee to the municipality or pay a fee to the municipality and transfer land to the municipality in lieu of any requirement to provide open spaces. Such payment or combination of payment and land transferred shall be equal to not more than 10% of the fair market value of the land to be subdivided . . . .". The Statute goes on to set forth other details relating to the open space contribution requirement.

Although Section 8-25 does not specifically limit the open spaces to 10 percent, many municipalities use 10 percent as a guideline. If affordable housing is involved in a subdivision application, the Statute provides certain limitations on open space requirements.

To date, neither the courts nor the Connecticut legislature have sanctioned any other "exactions" that can be imposed upon developers or land owners in Connecticut.

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The Yield Maintenance Prepayment Premium

In *River East Plaza, L.L.C. v. The Variable Annuity Life Company*, 2006 WL 2787483 (N.D. Ill. Sept. 22, 2006), the District Court for the Northern District of Illinois astounded lenders by ruling that a standard yield maintenance clause, employing an often used formula for calculating a prepayment premium, was an unenforceable penalty under Illinois law. The decision of the district court was appealed to the Seventh Circuit, 2007 WL 2377383 (7th Cir. August 22, 2007) who reversed the decision of the district court and upheld the yield maintenance prepayment provision.

The facts of *River East* are typical of many commercial loan transactions. The borrower, River East Plaza, L.L.C., obtained a mortgage loan from Variable Annuity Life Insurance Company, a subsidiary of the American International Group, Inc. The loan documents provided that, in the event the borrower prepaid the loan before maturity, the borrower would have to pay a premium equal to the "yield maintenance," which was intended to compensate the lender for any interest lost as a result of any prepayment. The yield-maintenance premium was calculated by using the rate of a Treasury security of a similar maturity to the loan and a similar reinvestment rate. The reinvestment rate is essentially the rate associated with the lender's replacement of the borrower's prepaid loan used in determining the lost interest resulting from the prepayment. A few years after the loan closed, the borrower voluntarily prepaid the loan but disputed the enforceability and amount of the yield maintenance premium.

The Northern District of Illinois concluded that under Illinois law, the enforceability of a prepayment clause depends on whether the premium is meant to be liquidated damages (an approximation of the lender's actual loss) or a penalty. Relying on two bankruptcy cases, the district court held that the yield maintenance provision found in the loan documents was unreasonable and unenforceable because it overcompensated the lender for the lost interest and, therefore, was a penalty. According to the court, the use of Treasury securities as the basis for determining the reinvestment rate overcompensates the lender if a risk differential is not added to account for the fact that a Treasury security has significantly less risk than a commercial mortgage. The use of Treasury securities to calculate a prepayment premium in the context of a real estate loan compensates the lender at the increased interest rate paid by the borrower in exchange for that lender's assumption of the higher risks associated with a commercial mortgage while at the same time relieving the lender of the burden of those bargained-for risks.

The decision of the district court was appealed and the Seventh Circuit considered whether the yield maintenance premium is a "disguised" penalty and

therefore unenforceable. At the onset, the Seventh Circuit acknowledged that Illinois had adopted the approach recited in the Restatement (Second) of Contracts § 356(1) and the statement of the Illinois Supreme Court that "some liquidated damages clauses are void as against public policy because they are penalties." The Court explained that, upon prepayment, a lender may reinvest the funds in another loan similar to the one prepaid, invest the funds in Treasuries, or simply deposit the funds in a bank account, and that these alternatives would yield different returns. The Court also noted that borrowers and lenders have alternatives to a yield maintenance provision; the lender can prohibit prepayment entirely or charge a fixed fee, a percentage of the then outstanding balance of the loan or a declining percentage of the loan. However, a borrower has alternatives as well: pay the full interest amount over the life of the loan or pay off the loan early by paying a much lesser amount calculated as the difference between the full present value of the schedule interest and the reinvestment rate. Even though the Lender might make a profit on the future use of the money and notwithstanding that the amount of the voluntary prepayment fee might be more than the borrower thought was fair, each set of alternatives had a bargained-for value and benefit to each party. The Court concluded that the "relative value of the alternatives for both parties leads us to believe that the clause is not punitive in nature," and noted that a contrary result "would have broad implications for both lenders and borrowers of mortgage-secured loans in Illinois, and might inadvertently effect a wide-ranging alteration of the law of real estate financing." The lower court decision was overturned.

The practical effect for lenders is to remember when negotiating and drafting prepayment provisions, they should consider the holding of *River East*. First, lenders should not only take measures to ensure that their prepayment provisions are enforceable under applicable state law but also should consider taking steps to ensure that such provisions are reasonable under federal bankruptcy law. To ensure that a prepayment provision is reasonable under federal bankruptcy law, lenders may consider adding a risk differential to the selected reinvestment rate or modifying its yield maintenance provision to expressly tie the borrower's obligation to pay a premium to its inability to replace the prepaid loan with another at an equal or greater rate. Second, lenders should be very careful not to use language in the prepayment provisions that would constitute liquidated damages. A suggested approach is to have language in the recitals of a mortgage or loan agreement stating that it is a material consideration to the lender making the loan that the lender receive the payments negotiated and further that the lender's ability to meet its obligations depends not just on the total amount repaid, but the timeliness of the payments, that if the borrower were to repay the loan prior to maturity that the lender would then have to reinvest the funds and may not be able to achieve the same (or greater) level of return and that the prepayment provision was specifically intended and agreed to protect the lender against this risk.

The other side of the coin is that borrowers need to fully understand the prepayment provisions and realize that some prepayment provisions can result in exorbitant numbers. This is often difficult for borrowers who can be heavily focused on more imminent business terms of the deal, such as interest rates, payment amounts, guarantees and other limitations that may be imposed by the lender. Borrowers need to familiarize themselves with the different types of prepayment provisions, run the numbers and truly understand their workings. If the prepayment provision is not acceptable, borrowers need to negotiate a different provision.

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Editor's Notes - James P. White, Editor

Diane Whitney has been elected President of the University of Connecticut Law School Foundation.

James White, Jr. has been reelected to another term on the Westport/Weston Chamber of Commerce Board of Directors.

Jim Dowling, John Kindl and Diane Whitney attended the Real Estate Exchange's Developer's Showcase on March 26 at the Hartford Convention Center. This is Connecticut's only Exhibition that focuses solely on Commercial Real Estate Development.

Lee Hoffman was recently appointed to the Steering Committee of the Connecticut Business and Industry Association's Environmental Policies Council.

Brad N. Mondschein was recently appointed to chair the Legislative/Regulatory Policy Working Group of the Environmental Committee of the International Council of Shopping Centers

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