ACREL News

President's Message

Chicago is ACREL's Kind of Town

With the lazy days of summer behind us, and continuing improvement in real estate activity and deals, I hope you have arranged to join us in **Chicago October 18-20** for our Annual Meeting – ***Harnessing the Winds of Change – Tips for Smooth Sailing on Rough Waters!*** If you haven't sent in your registration, do so right away! And don't forget to take advantage of our great room rate of $249 at the Renaissance Downtown hotel. All the information you need to register is on the website, or call the office (301.816.9811) if you have questions.

50 Shades of Grey? NOT What You're Thinking…!

The "open season" for membership nominations begins in September. We're actively seeking **younger and other qualified Fellows**, and **we need your help.**

To assist you in nominating a candidate, the following are posted on the website:

1. Proposal for Membership form
2. Required form of Resume for ACREL Nominees
3. Sample form of Seconding Letter

If you nominate a candidate, please take responsibility for completing and submitting the Proposal for Membership, including the candidate's resume and a separate, detailed statement of the candidate's qualifications. Be sure to identify at least two other College members who will second the nomination by independently certifying that the candidate meets the criteria for membership. If you have questions, feel free to call Jill or Henri in our ACREL office, Everett Ward (Chair of our Member Selection Committee) or Roger Winston (Chair of our Member Development Committee).

It is very important to our process that the proposer's statement provide detailed information listing the specific "give back" experiences of the nominee. More information regarding our **"give back" requirement** can be found in Section 5b of our **Guidelines for Member Selection**, which can be found on our website and on pages 22-28 of the ACREL 2012 Directory). It is not necessary to keep the nomination confidential from the candidate, and you will almost certainly need the candidate's input

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President's Message

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to provide the necessary supporting detail. Each year there are excellent candidates who are not admitted due to insufficient evidence that they satisfy the "give back" requirement. It is extremely important that nominating materials include *as full and complete information* as possible. If you would like to discuss the "give back" requirement with Everett or Roger before you talk to your candidate to avoid embarrassment or misunderstandings about this often misunderstood requirement, either of them would be happy to talk to you.

All forms and information, including seconding letters, must be submitted to the ACREL office via email for receipt by 5:00 p.m. ET on November 12, 2012 at memberselection@acrel.org.

State of the Union (Free of all Partisanship, PACs and Puffing)

Jonathan Shils, Tom Kaufman and I had a productive meeting in Rockville this summer with Jill and Henri, and are pleased to report that the affairs and finances of the College are in good shape. Jill has worked diligently to upgrade our financial systems and recordkeeping, as well as systematically looking at ways to cut costs without reducing value to our Fellows. The Executive Committee has spent quite a bit of time this year on various administrative tasks, including a lengthy "compliance with laws" and "best practices" project, resulting in changes in our auditor, our hotel meeting contracting process, conflicts of interest policies, certifications and transparency goals, various Bylaws revisions for both ACREL and the Foundation, and a review of our insurance and risk management practices. More information on these will follow. Our Programs Committee and the leadership of our Substantive Committees continue to do a spectacular job of providing useful programming and information to our Fellows through ACREL-only call-in programs, joint programming with ALI-CLE and MBA, and committee activities. We are delighted to have a large number of new Fellows serving on our Governance Committees and in the leadership structure for our Substantive Committees, as well as participating as speakers for our programs.

Leavin' on a Jet Plane…

We have a terrific lineup for our 2013 and 2014 meetings, so plan now to use your frequent flyer miles and join us for some terrific programs and outstanding venues:

March 14-17, 2013 Waldorf=Astoria
Naples, **Florida**

October 24-27, 2013, Four Seasons
Vancouver, Canada

March 27-30, 2014, Grand Hyatt
Kauai, **Hawaii**

October 16-19, 2014, InterContinental
Boston, Massachusetts

You Never Call, You Never Write…

As always, please let me know what's on your mind! I look forward to your comments and suggestions. And, I look forward to seeing you in Chicago in October!

Ann

Ann M. Saegert, President

STAFF BOX

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Raising Money for the Challenging Project: Using New Markets Tax Credits

by Denise J. Lewis, Honigman Miller Schwartz and Cohn LLP

Introduction

As practitioners, it is important to know of the many incentive program opportunities available so that we can guide and assist clients in making the most of their investments. For those development projects that face challenges and difficulties, creative use of incentive programs may make the project achievable. This presentation will highlight certain federal incentive programs that address the goal of turning financially distressed areas into "new markets" for commercial activity and growth.

Benefits from incentive programs are often increased where the resourceful practitioner can find ways to use federal incentives in combination, working with multiple layers of conventional and publicly-assisted financing. The incentives may make the difference in making the project financeable by:

- Making available lower cost equity investment for otherwise marginal projects, with the investor contributing capital to the project in exchange for tax credits and with the tax credits assuring the investor the desired return on investment.

- Improving the financial position of the developer and the project by reducing project costs and improving project cash flow. The result is improving the return on investment in the project.

- Reducing the cost of capital for the project, by reducing interest costs through sources of low interest loans.

A. Federal New Markets Tax Credits

1. A Brief Background Summary

Authorized by Congress in 2000 as part of the Community Renewal Tax Relief Act of 2000, the New Markets Tax Credit (NMTC) program has become one of the largest economic development programs supported by the federal government.[1] Designed to encourage private investment in low-income communities, the program is codified in Section 45D of the Internal Revenue Code (IRC). The tax credit program provides a significant reduction in the federal income tax liability for lenders or equity investors in economic development projects. Funds may be used to invest in a wide range of entities and activities so long as the projects are situated in low-income communities, defined generally as census tracts with a poverty rate of 20% or more. The NMTC program has gained in reputation due to its flexibility and adaptability with the range of investment vehicles and types of projects that can be covered. Significant areas of the country are eligible; based on the 2010 census data, 41% of U.S. census tracts are eligible for the NMTC program.[2] Several states have adopted their version of a new markets tax credit program focused on low-income communities including Illinois, Florida, Louisiana and Missouri.

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1 Seidman, Ellen, "The New Markets Tax Credit: A Valuable Tool for Economic Development," Living Cities Policy Series, Spring 2007.

2 Community Development Financial Institutions Fund, U.S. Department of Treasury, Financial Strategy and Research Department, June 2012.

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Unlike some other federal tax credit programs where allocations are determined at the state level, the NMTC program allocations are made at the national level by the Community Development Financial Institutions Fund ("CDFI Fund"), part of the U.S. Department of Treasury. The first allocations under the program were not made until 2003, with the first investments coming in late 2003 and early 2004. Over a short period, the program has gained substantially in support and acceptance. With $16 billion in allocation awarded through 2007, the allocations were increased with the economic recession, and $5 billion was awarded in each of 2008 and 2009. The program has also been used to respond to areas of the country experiencing disasters, with a $1 billion allocation included for qualifying investment in communities located in areas affected by Hurricane Katrina (§45D(f)(1)). NMTC allocation awards for the 2010 program round totaled $3.5 billion nationally. In early 2012, the most recent round of NMTC allocation was announced in the amount of $3.6 billion nationally, and this brings the cumulative total in NMTC allocation awarded to $33 billion over the life of the program. In the most recent NMTC round, there is also an emphasis on a Healthy Food Financing Initiative aimed at eliminating so-called "food deserts" in low-income urban and rural areas; and over 70% of the allocatees committed to funding of supermarkets, retail food outlets and other developments to foster this Initiative.[3] Annual congressional reauthorization is required for the NMTC program.

2. What Are New Markets Tax Credits?

The NMTC program offers a credit against federal income taxes for an individual or corporate investor making equity investments in eligible businesses and commercial projects. The amount of the credit is 39% of the amount invested as explained below. §45D(a)(2). The credit is taken over seven years, with a 5% credit for the year the entity makes the investment and for the two years thereafter, and a 6% credit for each of the remaining four years. §45D(a)(2). The present value of the credit is often cited in the range of 30% of the amount invested.[4]

3. How Does the New Markets Tax Credit Work?

There is a three phase process for this tax credit program, and the first phase is the allocation process. The CDFI Fund awards NMTC allocation to "Community Development Entities" (CDEs)[5] which function as financial intermediaries between the projects and the tax credit investors. There is a highly competitive process for the allocation, and the CDEs make commitments to a geographic region and investment goals in order to win the award. §45D(f)(1). For the allocations announced in 2012, nationally 70 CDEs received awards, and the average allocation amount was about $52 million. The CDEs negotiate allocation agreements binding them to these commitments. Note that the NMTC allocation itself is not a monetary award but rather a grant of authority from the CDFI Fund permitting the CDE to raise investment capital equal to the NMTC allocation award.[6]

3 Community Development Financial Institutions Fund, U.S. Department of Treasury, "2011 New Markets Tax Credit Program Allocation: Highlights of Allocation Round," February 23, 2012.

4 This assumes a discount rate of about 7 percent.

5 A CDE is a privately managed investment vehicle which is defined in the Act as an entity (1) whose primary mission (at least 60% of the entity's activities) is to serve or provide investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities through the residents' representation on the CDE's governing board or an advisory board (at least 20% representation), and (3) that is qualified through the CDFI Fund as a CDE.

6 New Markets Tax Credit Coalition, The New Markets Tax Credit Progress Report 2009, June 2009.

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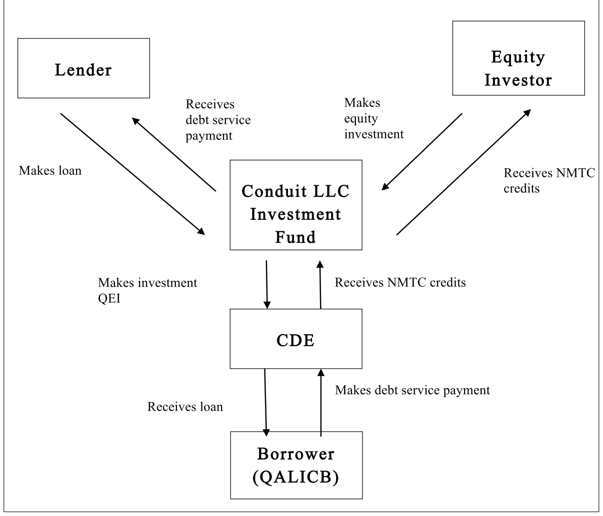
Next is the capital raising phase. Capital may come from a variety of sources, and it is used to make a "qualified equity investment" or "QEI" in the CDE. An interested tax credit investor sets up a conduit holding company (the "Investment Fund") into which capital is placed. Funds may flow into the Investment Fund as equity or debt. Typically the tax credit investor puts its money into the Investment Fund as equity. Other sources of equity for the Investment Fund may include government grant funds, fundraising proceeds, charitable contributions and equity paid in exchange for other tax credits such as brownfield credits and historic tax credits. It is also typical for the capital raised to include loans to the Investment Fund. The loan proceeds may come from an institutional conventional lender, from affiliates of the project developer, from state and local government loans or from tax exempt bond proceeds. All of these loan programs have their own special complications and are labeled in the NMTC structure as the "leverage loan." The IRS "blessed" a form of the leveraged model in Revenue Ruling 2003-20 and 2010-17.

The third phase is the investment phase. Figure 1 below outlines the typical structure for the investment phase for the NMTC program. The Investment Fund aggregates or bundles the capital from the various sources and makes the "qualified equity investment" or "QEI" in the CDE. It is this investment that triggers the eligibility for the tax credits. The QEI must be made in cash to the CDE and the QEI must remain invested for seven years. With the meeting of these requirements, the NMTC is earned and the investor is entitled to claim the tax credit over the seven years, provided the QEI is properly used by the CDE.

The CDE is obligated to use the QEI to invest in the types of projects specified in its allocation agreement with the CDFI Fund. Within twelve months after receipt of the QEI, the CDE must use at least 85% of the equity investment for "qualified low-income community investments" (QLICI). While the CDE is allowed to make four types of investments, under §45D(d) and Treas. Reg. §1.45D-1, most CDEs elect to make a capital investment or loan to a qualified business, called a "qualified active low-income community business" (QALICB)[7]. The QLICI funding by the CDE is most often structured as loans to the QALICB. For real estate development transactions, the QLICI loans are structured as construction financing with the customary security documents and collateral. These QLICI loans have below market interest rates and interest only terms for the seven-year compliance period. All or a portion of the QLICI loans may be forgiven at the end of the seven years, with the cancellation of indebtedness tax consequences to be taken into account.

Figure 1

Leveraged Structure



Note: This is a simplified diagram, which leaves out features such as fees and percent ownership of the different entities.

7 A QALICB must derive at least 50% of its gross income from active conduct of business in low-income communities (the "gross revenues test"), hold at least 40% of its tangible property in the low-income community (the "property test"), and perform at least 40% of its services in the low-income community (the "services test"). If the entity meets or exceeds the 50% level in the property test or the services test, the entity is deemed to meet the gross revenues test; if the entity has no employees but meets the property test by at least 85%, the gross revenues test and the services test are deemed to be met.

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4. Who Can Use the New Markets Tax Credit Program?

A wide range of entities have received allocations in one or more of the CDFI Fund allocation rounds. The CDEs generally fall into three types: 1) for-profit parent entities such as banks; 2) national nonprofit organizations; and 3) state and local government economic development authorities. Banking institutions are active participants in the NMTC arena and can function as CDEs as well as tax credit investors. These institutions sometimes also participate in making a conventional loan to the project which may be the source of the "leverage loan." Banking institutions have the additional incentive to participate in NMTC deals because the participation helps in meeting their Community Reinvestment Act (CRA) requirements. Examples of CDEs include Bank of America, National Trust for Historic Preservation, PNC Bank, Local Initiatives Support Corporation (LISC), U.S. Bancorp Community Development Corporation, Empowerment Reinvestment Fund and Goldman Sachs New Markets Fund.. A full list of certified CDEs, indicating allocation amounts received and geographic service areas, can be found at the CDFI Fund website at www.cdfifund.gov.

Low-income businesses that can qualify for the NMTC program range from manufacturing and service businesses, to community facilities such as child care centers and charter schools, to commercial and industrial projects such as retail developments, office building and warehouses, to mixed-use commercial and housing developments. There is a definite tilt toward real estate projects, with upwards of two-thirds of the NMTC allocation used over the years for real estate projects. This emphasis on real estate projects occurs in part because these projects can be more readily structured to avoid the pitfalls of the recapture provisions under the IRC.

There are restrictions on a CDE investing in residential rental property. §45D(d)(3). Property developed for residential rental purposes does not qualify. However, a mixed-use project with no more than 80% of gross income derived from residential rental units qualifies for the NMTCs and residential for-sale housing projects also qualify (though for mixed-use projects, only the non-residential portion is considered a qualifying investment). Low-income housing tax credits may be applied to the residential portion of a mixed-used project, as long as the NMTC and low-income housing tax credits do not apply to the same square footage within the overall project.

Certain uses and business activities are prohibited in NMTC projects, including massage parlors, golf courses, gambling facilities, liquor stores, country clubs, and hot tub, tanning or sauna facilities. These prohibited uses extend to the lessees of QALICBs.

5. Structuring New Markets Tax Credits for a Project

There are several hurdles to qualifying a project for credits under the NMTC program. The planned project must be located in an eligible low-income area defined by the census tract. A list of eligible census tracts meeting the criteria is published for each state and can be found at www.cdfifund.gov/what_we_do/acs/update-census-data.asp. The eligibility requirement is a poverty rate of at least 20%, or median family income less than 80% of the statewide median income or the metropolitan area median income. The eligible census tract listing has been updated based on the newest 2010 census data.

The next challenge for the developer is securing a commitment of NMTC allocation from a CDE. The project developer has to locate CDEs that have a business model and

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geographic focus consistent with the project. These parameters are stated in the CDE's allocation agreement with the CDFI Fund, and it is often a time-consuming task to find the right fit with a CDE. Typically, CDEs limit their allocation commitment to any one project to a maximum of $10 million, and thus for larger projects, allocation will have to be sought from multiple CDEs. The CDE's commitment of NMTC allocation to the project will also be dependent on identifying a tax credit investor to "purchase" the credits.

Negotiating satisfactory arrangements with a leverage lender is the next hurdle for the developer. The commitment of the tax credit investor and the CDE will be contingent on locating a leverage lender that will provide project funding to complete the dollars required to fund the project's Sources and Uses. All of the dollars have to come to the table at the same time. For the leverage loan that comes from a conventional lender or tax exempt bond financing, there is a special challenge with respect to the collateral structure providing security for the loan. The leverage loan cannot be secured by a mortgage on the project, given that this collateral is reserved to support the QLICI loans and not the leverage loan. Further, principal payments on the leverage loan are barred for the seven-year compliance period, and the lender has to agree to forbear from foreclosing for the seven years. Foreclosure and repayment of principal would trigger tax credit recapture. The institutional lender has to get comfortable with this very unusual collateral structure, and the lender will depend on the creditworthiness of the guarantors and the strength of the project's business model to assure repayment. Leverage loans funded by affiliates of the project developer or from state and local government loans do not typically face the same underwriting challenges but will be subject to the same collateral restrictions.

The equity investor may be contributing capital to "purchase" federal Historic Rehabilitation Tax Credits (HRTC), and this project structure would allow the combining of the benefits of the NMTC with a HRTC project. As another option, the equity investor may be acquiring tax exempt bonds and this would allow the combining of the benefits of tax exempt financing with NMTC as discussed below in the Case Study. The same may apply to an investor "purchasing" certain state tax credits who may contribute the equity through the NMTC structure. All parties benefit with this leveraged model, and the tax credit benefit is typically shared by the investor, the CDE and the project. The equity investor gets the benefit of the NMTC, the HRTC and the state tax credits. The CDE typically requires a percentage of the "qualified equity investment" as its compensation for its staff efforts, and the project benefits from the reduced cost of capital and the equity infusion.

Avoiding recapture is also an important consideration in structuring NMTC deals. The tax credit investor often insists on personal guaranties from moneyed parties associated with the project to cover payment to the investor if tax credits are recaptured. The project developer is thus strongly motivated to find ways to avoid recapture and thereby avoid a call on the personal guaranties. There is no vesting or "burn off" of NMTC so in the event of recapture the entire amount of the NMTC is recaptured plus penalties and interest. Recapture is triggered if a) the tax credit investor is paid back its QEI and it redeems its interest in the CDE or b) the CDE loses its status as a qualified CDE within the seven years the QEI is made. §45D(g).

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6. How New Markets Tax Credits Help Finance Projects

NMTCs are valuable because they provide a fairly flexible source of low cost equity. NMTCs can cover a broad range of project eligible costs beyond the more typical hard construction costs covered by other tax credits. Eligible costs can include project acquisition expenses and a variety of soft costs including accounting and legal fees. The limiting factors are that 1) the NMTC allocation has to be large enough to cover these additional costs and 2) the costs have to be reimbursed by the CDE to the developer as part of the QLICI investment or loan made. A fairly efficient market has developed for the "sale" of NMTCs, and investors are paying in the range of $.70 to $.80 for each $1.00 of NMTCs obtained. These dollars in the project are offset by the transaction costs which include the fees paid to the CDEs for making the NMTC allocation available. CDEs are requiring payment pegged at 6%-10% of the "qualified equity investment" as compensation for their staff efforts in managing the compliance process and filing the annual audit and other reports required. In addition, the developer will be required to pay the fees for its accounting and legal professionals as well as the fees for the professionals advising the tax credit investor and the CDE.[8]

An example will illustrate the utility of NMTCs. A developer plans to build an $11 million neighborhood shopping center with a supermarket anchor in a low-income community. The appraisal for the completed project comes in at only $8 million, and the conventional lender is only willing to make a $6.4 million loan, based on an 80% loan to value ratio. The developer may be able to raise $1.5 million of equity based on the project's net operating income, and there is $700,000 of financing from government and foundation sources, based on the estimated jobs created and goods and services provided by the project. There is a $2.4 million gap to be filled by NMTC project financing. The NMTC deal will include a total of $10.1 million funded into the Investment Fund from a combination of these sources: conventional loan, developer raised equity and government and foundation loans. These sources are aggregated for a "qualified equity investment" that passes from the Investment Fund to the CDE and earns $2.4 million in NMTCs. This $2.4 million fills the funding gap, and there are funds available to cover the $300,000 in transaction costs for this NMTC deal.[9]

Availability and use of the NMTC may increase an investor's rate of return on a particular development project, but the utilization of the credit requires forward planning. For example, leases can and should include provisions requiring the tenants to provide on a regular basis the data necessary to fulfill reporting requirements of the NMTC program. Practitioners should take special care in clarifying roles and responsibilities for drafting documents for NMTC transactions.

Further, NMTC projects tend to be complex and time-consuming, and the project needs to be of sufficient size to warrant the time investment and the high transaction costs. However, the complexity, competitiveness and relative success of the NMTC program has generated an industry of NMTC consultants,

8 Armistead, P. Jefferson, "New Markets Tax Credits: Issues and Opportunities," Pratt Institute Center for Community and Environmental Development, April 2005.

9 Local Initiatives Support Corporation, "LISC NMTC Basics," October 2008.

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accountants, and legal providers available to guide investors, developers, CDEs or aspiring CDEs through the appropriate application, certification and investment processes. Consultants have established development allocation management systems to, among other things: (i) track investors' funds into the CDE and QALICB, (ii) prepare reports required by the CDFI Fund, the IRS and investors and (iii) handle the various reporting functions.

B. Challenges in making public incentive programs work in combination: Case Study Mixed Use Development, Detroit Michigan

The case study shown in Figure 2 below highlights the complexity inherent in structuring a project to combine available public incentives and maximize the benefits. The subject project was owned by a for-profit developer entity, and that entity was wholly owned by a 501(c)(3) organization. The project received approval from the county government for a Section 108 HUD guaranteed loan in the amount of \$2.1 million. With the modest amount of environmental contamination present at the site, the project was approved for a federal Brownfield Economic Development Initiatives (BEDI) grant of \$2 million with the affiliated 501(c)(3) organization as the recipient, and the project was also awarded state brownfield tax credits. The developer worked to optimize a structure that would permit the \$4.1 million in grant/loan funds to be enhanced by NMTCs. To find out whether the project was an appropriate candidate for NMTCs, the developer had to work through the following checklist of issues.

Eligible census tract. The developer first determined that the project was located in an eligible census tract, with a poverty rate of 20% or higher.

Qualification as eligible NMTC business. The developer had to investigate CDEs and identify CDEs that had a business model and geographic focus consistent with the project. These parameters are stated in the CDEs allocation agreement with the CDFI Fund, and it is often a time-consuming task to find the right fit with a CDE. The developer identified a couple of Michigan-based CDEs that were interested in the project's business model.

Available NMTC allocation. The next hurdle was ascertaining that the CDEs had NMTC allocation that could be made available. There is healthy competition for any available allocation. Typically, the maximum allocation amount is \$10 million for an individual project. The developer's allocation need was for \$5.5 million. In order to enhance the \$4.1 million in grant/loan funds, the developer needed a commitment of \$1.4 million in capital contributed in exchange for the rights to receive the NMTCs, and this produced a total required NMTC allocation of the \$5.5 million.

Locating a NMTC Investor. The most serious challenge for the developer was locating the tax credit investor because this entailed the evaluation of the credit risk as well as the assessment of the project's business plan. While NMTCs are aimed at investments in distressed communities, the developer found considerable hesitation with respect to investing in a project in Detroit, given the depressed Detroit and Michigan economies. Considerable space in the project was being leased to entities affiliated with a local university, and the income stream from these leases gave the tax credit investor the underwriting reassurance needed for the project. The credit status of the university-affiliated tenants was key in persuading the county to provide the Section 108 HUD guaranteed loan and convincing the

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investor that there was reasonable assurance that debt service would be paid.

NMTC leverage loan structure. The developer decided to use what has become a fairly common model with a leverage loan structure. The mixed-use project had three tiers of loans as the BEDI grant and the HUD 108 loan were lent through the NMTC structure. The county loaned the HUD Section 108 loan funds to the Investment Fund formed by the tax credit investor, and that was Loan A in the chart attached. This was the senior loan in the priority structure. The affiliated nonprofit loaned the proceeds of the BEDI grant to the Investment Fund, and this is Loan B in the chart attached. The NMTC investor contributed payment for the NMTCs to the Investment Fund as a capital contribution, and the CDE in turn converted the equity payment to Loan C in the chart attached. The funds from the three loans/grants were pooled at the Investment Fund level and then contributed to the CDE as a "qualified equity investment" of $5.5 million. The CDE passed the funds to the developer in the form of Loans A, B and C.

Loan A mirrored the interest rate for the HUD 108 loan and had somewhat below market rate terms for interest and maturity. Loan A was interest only for the first seven years due to the recapture rules for NMTCs. The fixed rate of interest rate for Loan A was 6%. Loan B of the BEDI grant funds was subordinate debt with a low interest rate of 1% and a long maturity. Loan C of the NMTC equity had a subordinate status and also had a low interest rate of 1.965% and a long maturity. The interest rate for Loan C was set on a basis to cover the annual fees and expenses of the CDE with respect to this transaction.

Arrangements were negotiated with the tax credit investor at the end of the seven-year compliance period for the sale of its interest in the Investment Fund to the developer for a put price. That put price is often nominal and for this transaction was set at $1,000. Once the developer, or its designee, exercises the put and owns 100% of the Investment Fund, the developer can arrange for forgiveness of Loan B and Loan C. There are tax consequences to the debt forgiveness, and there could be cancellation of indebtedness income to the developer. This developer can choose to leave Loans B and C outstanding but have the Loans held by the affiliated nonprofit and thereby delay the forgiveness of the Loans until some future point when the tax penalty is reduced.

NMTC transaction costs. A NMTC transaction will require the involvement of multiple layers of professionals for the developer, the CDE and the tax credit investor. For that reason, transaction costs for NMTC financings tend to be high. In the analysis chart attached, the transaction costs including the professionals and the CDE closing fees are estimated at $475,000. ■

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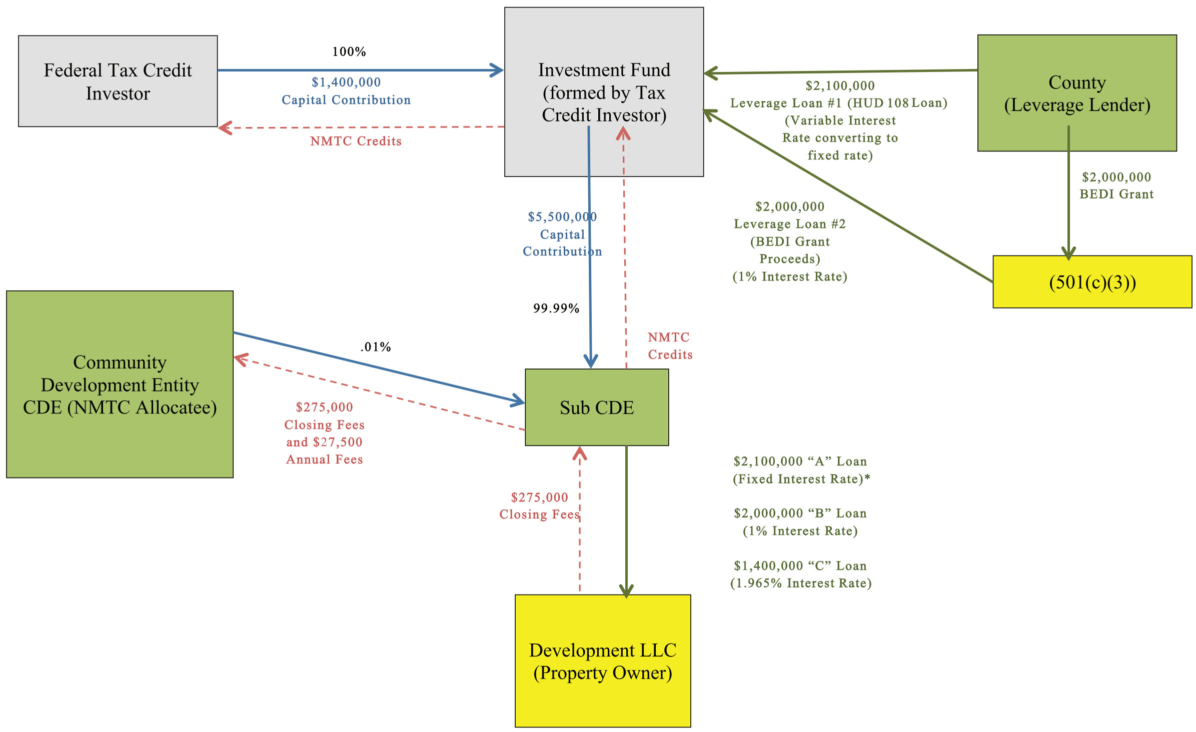
FIGURE 2 - ORGANIZATIONAL CHART FOR MIXED-USE DEVELOPMENT

DETROIT, MICHIGAN



*Interest rate will be fixed to approximate the estimated fixed interest rate on the HUD 108

Meetings Calendar

2012 Annual Meeting
October 18-21, 2012
Renaissance Chicago Downtown
Chicago, IL

2013 Mid-Year Meeting
March 14-17, 2013
Waldorf=Astoria
Naples, FL

2013 Annual Meeting
October 24-27, 2013
Four Seasons Hotel
Vancouver, BC, Canada

2014 Mid-Year Meeting
March 27-30, 2014
Grand Hyatt Kauai
Kauai, HI

2014 Annual Meeting
October 16-19, 2014
InterContinental Hotel
Boston, MA

Liability of Architects and Engineers for Observation and Inspection Services – Breaking the Bonds of Privity

by William H. Locke, Graves Dougherty Hearon & Moody, Austin, TX

In early September, the Texas Supreme Court on the court's return from its Summer recess issued its Petition Denied order in *Black +Vernooy Architects v. Smith*, 346 S.W.3d 877 (Tex. App. – Austin 2011). This construction law case presented the court with an issue of first impression in Texas and one with national practice implications. By issuing its Petition Denied, the court let stand the Austin Third Court of Appeals' decision finding that Texas law does not impose on an architect undertaking construction inspection services a duty to the public to detect and report to its client obvious construction defects and deviations from the architect's drawings and specifications. In this case, the architect undertook contract administration services under the standard AIA form architect's agreement, which includes an obligation to report known deviations to the owner. Unfortunately in this case, the architects failed, and admitted that the builder's deviations from the plans were obvious, but missed by the architect.

Petitioners' counsel has advised this writer that they will file a request with the court that it withdraw the Petition Denied order and hear oral arguments. Prior to the court's issuance of its Petition Denied order, it had requested, and the parties had filed, briefs on the merits of the case. Also briefs by three *amicus curiae* were filed. Supporting the architect's position are two *amicus curiae* briefs, one by the Texas Civil Justice League and one filed on behalf of the Texas Society of Architects and the American Council of Engineering Companies of Texas. The Texas Trial Lawyers Association filed an *amicus* brief supporting the petitioners' position. The briefs by the Texas Society of Architects, the American Council of Engineering Companies of Texas, and the Texas Trial Lawyers Association were filed in the gap between the court's decision and the publication of its decision, and so the court issued its order without the benefit of these briefs.

A more detailed discussion of this case, including pictures of the construction defects, and of cases in other jurisdictions is found in the article with the same title posted on the ACREL website under the Insurance Committee's webpage. The Court of Appeals in a rather dramatic fashion stated the issue as follows:

> Unquestionably, the Architects (Black+Vernooy Architects) entered into a contractual agreement in which they agreed to make periodic visits to the construction site, to report observed deviations from the design plans to the Maxfields (the home owners), and to guard the Maxfields against defects in the construction of the home; however, the Smiths and the dissent ask us to do something that has never been done in the history of Texas jurisprudence: they request this Court to transform and extend the contractual duty owed to the Maxfields into a common law duty owed to the Smiths (the petitioners) as visitors to the Maxfields' home. Although our sympathies extend to the Smiths for the suffering they have unjustly been forced to endure, this Court

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Liability of Architects ...

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> simply cannot create a new common law duty in order to uphold the relief that they sought against the Architects. *Id*. at 881. (Parenthetical identification of the parties added by this writer.)

This case concerns serious injuries suffered by two house guests when a balcony they were standing on collapsed. Since the house guests have no contract with the architect they are not "in privity with the architect". The injured house guests ask, if an owner and a house guest were on the balcony, would the architect be liable to the owner for her injuries but not to the guest for her injuries? What relevance should privity play? What relevance should contractual language play? Does an inspecting architect or engineer have a duty to third parties independent of its contractual duty to the owner?

Under the AIA standard architect agreement there are five phases of service: § 3.2 Schematic Design Phase Services; § 3.3 Design Phase Services; § 3.4 Construction Documents Phase Services; § 3.5 Bidding or Negotiation Phase Services; and § 3.6 Construction Phase Services. The owner's agreement with the architect may be limited to design phase services and may exclude inspection or supervision services. Construction Phase Services under the AIA architect agreement include evaluation of the work and certifications of payment and completion. Architects and engineers are licensed to perform these services.

Construction involves numerous people who are not in privity with the architect, but who can be injured by the negligent performance by an architect of its Construction Phase Services: contractors and subcontractors, their employees, construction lenders, subsequent owners, and invitees like the injured house guests in this case. The injuries may be purely economic losses or bodily injuries.

The AIA B101-2007 Standard Agreement Between Owner and Architect provides that the architect is to provide the following Construction Phase Services:

> **§ 3.6 CONSTRUCTION PHASE SERVICES …**
> **§ 3.6.2 EVALUATIONS OF THE WORK**
> **§ 3.6.2.1** The Architect shall visit the site *at intervals appropriate to the stage of construction*, or as otherwise required in Section 4.3.3, to become *generally familiar* with the progress and quality of the portion of the Work completed, and to determine, *in general, if the Work **observed*** is being performed in a manner *indicating* that that Work, *when fully completed*, will be in accordance with the Contract Documents. However, the Architect shall *not be required to make exhaustive or continuous on-site inspections* to check the quality or quantity of the Work. *On the basis of the site visits*, the Architect shall keep the Owner *reasonably* informed about the progress and quality of the portion of the Work completed, and report to the Owner (1) ***known*** deviations from the Contract Documents and from the most recent construction schedule submitted by the Contractor, and (2) defects and deficiencies ***observed*** in the Work. (Underlining, italics and bolding added by author.)

The case before the court arises out of the prior edition of the AIA architect's agree-

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ment form, which in addition to the above language in the 2007 form, contains the following additional language which has not been carried forward into the B101-2007:

> The Architect, as a representative of the Owner, shall … ***endeavor to guard*** the Owner against defects and deficiencies in the Work…. *(Emphasis added.)*

Your writer became interested in the case through reading articles about the case appearing in the local newspaper and later when the trial court's judgment in favor of the plaintiffs, was first upheld by the Court of Appeals and later overturned when the Court of Appeals withdrew its opinion and substituted another opinion sustaining the architect's position. Between the original opinion and the substitute opinion, the makeup of the court changed.

In this case, Lou Ann Smith and Karen Gravely sued Black + Vernooy Architects for negligence in connection with injuries Smith and Gravely suffered when the second-floor balcony of a friend's home collapsed while they were standing on it. Over a year after the home was completed, Karen Gravely and Lou Ann Smith visited the Maxfields' vacation lake house. At some point during the visit, Karen and Lou Ann stepped out onto the upstairs balcony to view the sunset over the lake. A few seconds later, the balcony separated from the exterior wall of the home and collapsed, causing the two women to fall approximately twenty feet to the ground with the 3000 pound balcony. Lou Ann was rendered a paraplegic as a result of the injuries that she suffered in the fall, and Karen suffered a broken finger, a crushed toe, and multiple bruises. Karen Gravely and the Smith family sued the Maxfields, Nash, the general contractor, and the architects for negligence in connection with the collapse of the balcony.

In October 2000, Robert and Kathy Maxfield hired the architects to design a vacation home. When the Maxfields hired the architects, they signed an agreement based on forms promulgated by the American Institute of Architects that are used nationwide. As directed by the agreement, the architects designed the Maxfields' residence and prepared construction drawings and specifications. After hiring the architects, the Maxfields later hired Nash as the general contractor for the project. When Nash was hired, the Maxfields and Nash entered into a construction contract that was also based on forms promulgated by the AIA. Under the construction contract, Nash was responsible for building the home and was authorized to hire subcontractors to facilitate the construction. During the construction, Nash hired a subcontractor, Rodriguez, to build the balcony. When Rodriguez built the balcony, he did not do so in compliance with the design drawings. The design drawings required that the metal pipes supporting the balcony be welded to steel plate tabs, which would then be bolted to the balcony. As constructed, however, the metal support pipes were attached to the balcony using thin metal clips. The design drawings also required that a metal support piece, referred to as a "joist hanger," be used to reinforce the attachment of each of the balcony joists to the exterior wall of the house. In the actual construction of the balcony, however, no joist hangers were used. Although required by the design drawings, the balcony handrail was not bolted to the house. Finally, the design drawings called for the balcony to be attached to the exterior wall of the house by bolting it to a one-and-one-half-inch-thick rim joist and another one-and-one-half inches of wood blocking. Despite these speci-

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fications, the balcony was not attached to the house using bolts, a rim joist, and blocking, but was instead merely nailed to a one-half-inch piece of plywood.

In addition to an $84,000 fee for design services, the Maxfields paid the architects a $16,800 fee to provide "contract administration services" during the construction of the residence. The agreement to provide contract administration services stated that the architects would, among other things, "report to the Owner … known deviations from the Contract Documents" and "endeavor to guard the Owner against defects and deficiencies in the Work." In the course of the contract administration process, the architects took multiple photographs depicting what they acknowledged at trial to be open and obvious structural defects in a prominent feature of the Maxfields' home—the second-floor balcony overlooking the lake. The architects reviewed these photographs, but failed to identify the structural defects or bring them to the Maxfields' attention. The architects' senior architect, Black, testified that in providing contract administration services to the Maxfields, the architects were required to make periodic visits to the site to observe the construction and determine whether it was in compliance with the construction documents. During these visits, an intern took photographs of the balcony, which Black later reviewed to determine if the balcony was built in compliance with the design intent.

Looking at these photographs during his testimony, Black testified that they depicted that the handrail was not connected to the wall as required, the metal support pipes were not attached with welded and bolted tabs as required, joist hangers had not been used as required, and the balcony was not bolted to the house in the manner required by the design drawings. The plaintiffs' expert witness testified that the metal support pipes were attached to the balcony using a type of thin metal clip that would generally be used to support "lightweight items such as electric conduit or plumbing piping."

Black further testified that the absence of the required rim joists and welded tabs was obvious from the photographs. Black also testified that one of the intern's photographs, taken from the interior of the house, depicted plywood where the rim joist and blocking should have been. Black acknowledged that at the stage of the framing process depicted in the photograph, the rim joist should have been in place and visible, and that the rim joist was critical to the structural integrity of the balcony. When asked whether the absence of the rim joist was open and obvious at the time the architects reviewed the photographs, Black answered, "It's obvious now. We didn't notice." Black stated that if he had noticed the defects visible in the photographs, he "absolutely" would have requested that the contractor correct them. Expert witnesses for both sides testified that the absence of the rim joist was obvious in the photographs.

Nash and the Maxfields settled with the plaintiffs prior to trial. Under the terms of the settlement, Nash agreed to pay $1.4 million, and the Maxfields agreed to pay $250,000. Ultimately, a jury trial was held to address the issue of the architects' liability. A jury found that the injury was caused by the negligence of (1) the architects who designed the home (10%), (2) the general contractor who built the home (70%), and (3) the framing subcontractor who installed the balcony (20%).

In determining whether a legal duty exists, common law theory involves balancing of the following factors: (1) the risk and fore-

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seeability of injury, (2) the social utility of the actor's conduct, (3) the consequences of imposing the burden on the actor, (4) any other relevant competing individual and social interests implicated by the facts of the case, (5) whether one party has superior knowledge of the risk, (f) the right to control the actor whose conduct precipitated the harm, and (6) the magnitude of the burden of guarding against the injury.

The Smiths argue on appeal to the Texas Supreme Court that due to the dangers resulting from faulty construction and due to the public's reliance on architects, "public policy demands that contractual privity not be an indispensable requirement for a duty of care to houseguests, or other foreseeable users of the balcony." They argue that the Court should employ a balancing test in determining whether to find that an architect performing construction inspection services has a duty to third parties not in privity with the architect. They argue that on balance, foreseeability of the risk of injury to persons not in privity with the architect outweighs the social utility of encouraging architects to undertake such services without risk of liability to parties not in privity. The Smiths argue that requiring an architect to have more than a "blind eye" in its observations is not a heavy burden. The Dissent in the Court of Appeals made the following argument:

> Finally, the consequences of extending this duty to third parties are not so burdensome to the architect as to outweigh the remaining factors in favor of doing so. I disagree with the majority's contention that extension of this duty to foreseeable third parties will require an architect providing contract administration services to act as a guarantor or insurer of the work of the general contractor. On the contrary, the architect is required only to act in a reasonable and prudent manner, just as anyone else must do in order to avoid negligence liability. It cannot be a particularly onerous burden to expect an architect providing contract administration services to refrain from "clos[ing] his eyes on the construction site" and then "disclaim[ing] liability for construction defects that even the most perfunctory monitoring would have prevented." *Citing First Nat'l Bank of Akron v. Cann,* 503 F.Supp. 419, 436 (N.D. Ohio 1980), *aff'd*, 669 F.2d 415 (6th Cir. 1982). BVA Dissent at 905.

The respondent architects argue that creating this new duty would make design professionals liable to anyone hurt by a dangerous condition created by a contractor's failure to follow design plans. They state that such liability would be imposed even though the professionals (1) did *not* create the dangerous condition, (2) did *not* agree to control the construction work or exercise actual control over that work, and (3) did *not* guarantee or ensure to the owner that the contractors would follow the design plans. The architects argue that the consequences of creating this new tort duty would force architects to charge their clients enormous fees to cover the costs of the exhaustive and detailed investigations that would occur and the high malpractice premiums that insurers would assess because of the massively increased risks. They argue that many owners of small-scale projects would choose to forgo an architect's contract administration services. They point out that neither Texas common law nor any statute imposes contract administration duties on architects. The assumption of such duties is strictly a matter of contract between the archi-

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tect and its client. Under the 1997 B101, the subject of this case, the architects argue that an architect has only a limited contractual duty to "endeavor" to guard the client against defects in the construction work. They argue that an architect discharges that duty by intermittently visiting the building site and by reporting to the client "known deviations" from the design plans that are observed. Black argues he did what he said he would do. He argues that, based on his observations, he did not actually know of the deviations that existed that resulted in the injuries to the Smiths. He argues that the court should not rewrite the architect's agreement to require the inspection, detection, and reporting of "visible and obvious defects affecting critical safety and structural integrity aspects of the building that the architects should have seen when visiting the building site."

The Texas Society of Architects and the American Council of Engineering Companies of Texas in their *amicus curiae* brief argue that the issue is not a question of no-duty-because-of-no-privity with the injured house guests, but a distinction between the liability of one who is a "misfeasor" versus the non-liability of one who is a "nonfeasor". They argue that "Texas tort law has always distinguished between tortfeasors who create a dangerous condition and those who merely fail to prevent the plaintiff's injury, holding that the former owe a duty whereas the latter do not." *Amicus* brief p. 23. They argue that "This is a non-feasance case…. The Architects did not build the balcony in a dangerous manner…. Petitioners were injured because the Builder or its subcontractor improvidently and unilaterally substitute the wrong materials and methods for its construction." *Amicus* brief p. 25.

Supporting the petitioners' appeal, *amicus curiae*, the Texas Trial Lawyers Association, notes

> This court owes *amicus curiae* Texas Civil Justice League a debt of gratitude for making explicit what *Black +Vernooy* only implies: that this case is about restoring to architects and engineers the defense of privity. By giving conclusive weight to Black + Vernooy's privity argument, the Austin court of appeals has turned Texas's jurisprudential clock back fifty years and undermined the Texas Legislature's careful balance of public policy interests. *See Black + Vernooy Architects v. Smith*, 346 S.W.3d 877, 884 (Tex. App.—Austin 2011, pet. filed)(*en banc*). *Amicus* brief p. 3.

The Texas Trial Lawyers Association quotes the following discussion of this historical evolution from the AIA's website

> Once insulated from liability exposure by the concept of "privity" (derivative rights and responsibilities based on contract), a 1957 decision by a New York appeals court, *Inman v. Binghampton Housing Authority* (3 N.Y.2d 137, 143 N.E.2d 895), stripped architects and engineers of this protection. In *Inman*, the court found an architect and engineer liable to parties to which they were not in privity.
>
> As a consequence of *Inman*, suits against architects and engineers proliferated. Architects and engineers found themselves owing a duty of care to a variety of parties to whom no duty had been previously owed, nor ever contemplated. Eventually, the state legislatures responded to this perilous situation by adopting laws known as statutes of repose.

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Amicus brief p. 3 quoting from American Institute of Architects, Statute of Repose Summary, Model Architect and Engineer Liability Laws, http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aias078873.pdf (last visited Aug. 29, 2012). The TLTA as *amicus curiae* notes "That is exactly what happened in Texas. In 1969, the Legislature passed the statute now codified as § 16.009 to shield 'architects, engineers and others involved in design, planning or inspection of improvements to real property' from the threat of indefinite future liability" *Amicus* brief p. 3.

Will the Texas Supreme Court take on the appeal? If you were the judge, the jury, what would be the outcome? ■

ACRELades

The Midwest Real Estate News published its Best of the Best list in *Midwest Real Estate*. Chicago-based Arnstein & Lehr's Real Estate Group, co-chaired by Fellow **Allan Goldberg**, ranked first among Midwest law firms, with 2,287 transactions completed in Illinois, Indiana and Wisconsin.

Much news from Texas! The planning committee of the State Bar of Texas Annual Advanced Real Estate Course gives several awards each year. One of the awards is the Weatherbie Workhorse Award (named after ACREL Fellow **David Weatherbie**). The award is given annually "to one attorney who - for years, even decades - has been a stalwart of Texas Bar Real Estate CLE without seeking - or receiving - recognition for his or her contributions. This is an attorney who quietly and consistently makes quality contributions to the continuing legal education of the Real Estate Bar. The recipient is an attorney who always says "yes" when asked, and who always makes us proud. Simply, the recipient is a volunteer speaker and author on whom we have come to depend, without even being aware of our reliance. The Weatherbie Workhorse Award is our chance - as a Section of the Bar - to thank someone who has given so much, for so long, and who may never receive any other formal recognition for having done so. It's an award that comes from our heart." This year's recipient is **Doug Becker**.

Another award is for outstanding speakers and papers presented during the prior year's course. The Jerry Charles Saegert Award for "Best CLE Paper" is given for the best article presented at the previous year's course as determined by the planning committee for the current year's course. This year's recipient was **Bill Locke** for his paper, Annotated Insurance Specifications. Bill has shared his materials with the ACREL insurance committee. (*And yes, the award is named for **Ann Saegert's** cousin…*)

ACREL Fellow **Doc Watson**, Chair of the Real Property, Probate, and Trust Law Section of the State Bar of Texas, awarded the 2012 Distinguished Texas Real Estate Attorney Lifetime Achievement Award to **Chuck Jacobus**. "It is the highest award the State Bar of Texas gives in real estate law and to win it is kind of mind numbing," Jacobus said. "It has been awarded 13 times and the people who received the award before me were icons of the industry. To be considered in that group is a great honor." ■

Report to ACREL re: American Arbitration Association National Construction Dispute Resolution Committee Meeting June 12, 2012

Before reporting on the committee activities, on July 13, 2012 the American Arbitration Association announced that India Johnson, Senior Vice President and Chief Strategy Officer at the American Arbitration Association has been promoted to the position of Acting Executive Vice President in anticipation of advancing to be the President and Chief Operating Officer on January 1, 2013. She will be succeeding William K. Slate II, the current President and Chief Operating Officer who announced his planned retirement last September.

The Associated General Contractors hosted the June 12 meeting at its headquarters in Washington, D.C. The new chair of the NCRDC, Dr. Patricia Galloway welcomed the industry representatives who were in attendance. Michael Marra, AAA Vice President discussed the state of the industry, Educational and Webinar events and AAA efforts to reach out to the construction industry.

India Johnson, who at the time of this meeting was a AAA Senior Vice President, provided the attendees with an update of the AAA business operations and efforts to include more industry professionals on the committee.

Brian Perlberg, Director and Senior Counsel of AGC delivered a luncheon address in which he discussed the new versions of AGC's family of construction documents, commonly referred to as the Consensus Documents. One of his main points is that these documents attempt to mitigate disputes moving further along the dispute resolution continuum. The documents can be found at https://www.consensusdocs.org.

Continuing its efforts to control the cost and time of arbitrations, some suggestions made by AAA included:

Simultaneously conducting mediation while preparing for arbitration

Use of the chess clock by the arbitrators to keep the parties presentation of evidence on track

Arbitrators working with the parties to propose a budget for the process

Some of the upcoming AAA education webinars are:

September 13 Effective Use of Experts in Construction Arbitration

October 16 Managing the Costs of the Exchange of Electronically Stored Information

November 1 Innovations in ADR

November 13 Construction Law and Arbitration Update

You can register on line at www.adr.org.

The next meeting will be on December 6, 2012 in Washington, D.C. at a site to be determined. If any Fellow has an issue that they wish the NCRDC to address please contact me (ssklaradr@comcast.net) or Bryan C. Jackson (bjackson@allenmakins.com).

Respectfully submitted.

Stanley P. Sklar. Esq.
ACREL Representative


Canada in the Fall!
ACREL Annual Meeting
Four Seasons, Vancouver, BC
October 23-27, 2013
SAVE THE DATE!
ACREL Mid-Year Meeting
Grand Hyatt, Kauai, Hawaii
March 27-30, 2014