Commentary

<u>Distressed Real Estate: When Monitoring Investments, Determine What's Vested</u>

by David P. Waite

Perhaps the most important goal of any real estate developer and the capital source involved is to preserve land use entitlements and discretionary approvals once obtained. This goal is of paramount significance in the current real estate cycle.

Preserving Entitlements

In a workout or restructuring (e.g. recapitalization of distressed debt), a thorough evaluation of the entitlements and development rights that have been successfully secured by the project sponsor is required. A developer may have obtained certain approvals from a city or county such as a general plan amendment, a rezoning of the property, a tentative and final tract map approval, or even a development agreement all accompanied by a certified Environmental Impact Report ("EIR"). In most jurisdictions, however, the entitlements will lapse if the project is not implemented within the time periods specified in the approvals and permits. All approvals may be entirely lost if not timely implemented.

What's Vested?

The critical issue to be evaluated when trouble looms on the horizon is whether the entitlements and development rights remain active, and to what extent, if any, have those rights legally "vested" so as to create a constitutionally protected right to proceed with the project when the market rebounds. In short, "vested rights" are the gold standard in the complex world of land use entitlements, and they allow the project sponsor and the capital source to control the timing of resumption of development activity to the market conditions, and not the reverse. Properly secured and implemented, vested rights allow a developer to position a project on the leading edge of a rebounding development cycle.

The Avco Rule

Under California law, a landowner has a vested right to complete construction of a project in accordance with the terms of a building permit if the owner has performed substantial work and incurred substantial liabilities in good faith reliance upon a permit validly issued by the government. The common law "Avco Rule", based on the California Supreme Court's decision in *Avco Community Developers, Inc. v. South Coast Regional Commission*, sets the standard in California for "vesting" development projects.

In Avco, the property owner obtained tentative and final subdivision map approvals, and was in the process of constructing storm drains, improvements of utilities, and similar facilities for the subdivision tract. However, <u>no building permits had been issued for vertical unit construction.</u> Although Avco spent nearly $2,000,000 on construction costs, the California Supreme Court held that the commencement of infrastructure improvements <u>did not</u> rise to the level of "substantial improvements and costs" necessary to vest the project.

Implementing Building Permits for Vertical Construction

In contrast, where building permits have been issued, an owner has a vested right to complete construction after issuance of a building permit, even in circumstances where such a permit has lapsed due to delay caused by an economic downturn.

In Pardee Construction Company v. California Coastal Commission, the Court of Appeal held that

"where
[a] construction company allowed building permits to expire as a result of [a] decision to delay construction due to economic downturn, and where [a] construction company made no change in [the] condominium project, [a] construction company did not lose its vested rights as [a] result of lapse of building permits."

In *Pardee*, the landowner commenced construction of a 231-unit condominium complex in San Diego and completed its rough grading, desilting basin, drainage system and foundations for all 231 units. *Pardee* completed 152 units, but postponed construction on the final 79 units after framing due to a slowing market and allowed the building permit to lapse. When *Pardee* was ready to complete construction on the remaining 79 units a few years later, the City required a new building permit, and the State required a Coastal Commission Permit. The Court of Appeal found that *Pardee* made substantial investments and improvements in reliance upon the permits issued, and therefore had a vested right to complete the project. The Court also determined that the intentional lapse of the building permits due to the economic downturn <u>did not</u> waive the vested rights or require *Pardee* to obtain the newly enacted Coastal Commission Permit. As stated in *Pardee*, "[w]here a developer allows a permit to lapse for lack of activity, such fact is but some evidence bearing on the issue of abandonment or waiver of a vested right." Subsequent cases have upheld the Court's ruling in *Pardee* reaffirming the notion that "obtaining a valid building permit is a pre-condition to the acquisition by the builder of a vested right to continue a project" and that once obtained "the right to proceed with the project is controlled by constitutional principles and not by municipal ordinance or policies."

Statutory Vested Rights

In response to the harsh *"Avco Rule,"* California initiated several legislative reforms. For example, a development agreement approved under California's development agreement statute (Government Code Section 65864, et seq.) provides the developer with the "vested right" to proceed with a project-often for a period of 10 years or more-in accordance with "existing policies, rules and regulations, and subject to conditions of approval" in effect when the development agreement became effective. Additionally, under California's Subdivision Map Act, an approved "Vesting Tentative Map" provides the subdivider with the "vested right" to proceed with the development of the project in accordance with the local ordinances, policies and standards in effect when the map application was "deemed complete."

Conclusion

The foregoing principles highlight the need for the project sponsor and the capital source to evaluate the status of the target project entitlements and approvals, as well as their duration. More importantly, it is essential that the project sponsor and the capital source determine whether and to what extent the development rights can be sufficiently "vested" to create constitutionally protected development rights to sustain a cessation of development activity during an economic downturn. The result will be to preserve the value of the project created by the land use entitlements and approvals, and to position the project for prompt, timely and nimble implementation as market conditions improve.

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