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2018 Arizona Legislative Updates Affecting Commercial Real Estate and Lending (June 2018)

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Judgments (HB 2240)
Current Arizona law (A.R.S. §§ 12-1551, 12-1611 and 12-1612) allows a judgment to be enforced by writ of execution only within five years of its entry, unless it is renewed. A judgment is typically renewed by filing an affidavit for renewal with the clerk of court within 90 days prior to the expiration of the judgment. If the judgment is renewed, the judgment creditor gets an additional five years to enforce it. HB 2240 extends the five-year effective period (for both original judgments and renewals) to **ten** years, but does not include a retroactivity provision. It is therefore unclear whether the effective period of any unexpired judgment that was entered or renewed under the current statute will automatically be extended for an additional five years when HB 2240 becomes effective. Until definitive judicial guidance is issued, judgment creditors should consider renewing judgments under both a five and ten-year renewal schedule.

Data Security Breaches (HB 2154)
Current Arizona law (A.R.S. § 18-541 et seq.) requires a person who owns or licenses unencrypted personal information (the definition of which has been expanded by HB 2154) to conduct a reasonable investigation of a possible breach of personal information and notify the affected individuals in an expedient manner, subject to the needs of law enforcement. A person who maintains data must cooperate with the owner or licensee of the data and share relevant information relating to the breach. Notification must generally be given through written, electronic or telephonic notice. (Substitute notice may be used only if the cost of providing notice exceeds $50,000 or the number of affected individuals exceeds 100,000.) A person who fails to comply with the foregoing breach notification requirements is subject to a civil penalty of $10,000 per violation.

HB 2154 requires notices to be given to affected individuals in the prescribed manner *within 45 days* of the determination of a breach (a "security incident") and to contain certain specified information. Telephonic notices must be given by contact directly with the affected individuals and not through a prerecorded message. Notification must also be given to the three largest nationwide consumer reporting agencies and to the AG if the breach affects more than 1,000 individuals. Any person who maintains but does not own or license personal information must notify the owner or licensee of a possible breach as soon as practicable. HB 2154 increases the civil penalty for a knowing or willful violation of the foregoing requirements from $10,000 per breach to $10,000 per affected individual (but the maximum civil penalty from a breach or series of related breaches may not exceed $500,000). The AG may also seek restitution for the affected individuals.

This firm has experience in assisting clients with data breach responses and can answer questions and offer knowledgeable assistance in this regard.

Fintech/Regulatory Sandbox Program (HB 2434)
HB 2434 requires the Arizona Attorney General (**AG**), in consultation with applicable state agencies, to establish a Regulatory Sandbox Program (**RSP**) allowing persons (including current licensees) limited access to the Arizona market to develop and test *innovative financial products or services* without licensure or other authorization. Arizona is the first U.S. state to adopt a regulatory sandbox, a concept borrowed from the UK, UAE, Singapore, Australia, Canada and other foreign jurisdictions. The AG is to accept and review each application for entry into the RSP to test an innovation. ("Innovation" for this purpose means the use or incorporation of new or emerging technology or the reimagination of uses for existing technology to address a problem, provide a benefit or otherwise offer a product, service, business model or delivery mechanism that is not known by the AG to have a comparable widespread offering in Arizona.)

The applicant must demonstrate that it is subject to the jurisdiction of the AG (through incorporation, residency, presence agreement or otherwise) and has established either a physical or virtual location that is accessible to the AG where required records and data will be maintained. The application must demonstrate that the applicant has an adequate understanding of the innovation and a sufficient plan to test, monitor and assess the innovation while ensuring that consumers are protected from a test's failure. Persons that already possess a license or other authorization under state laws regulating a financial product or service must file an application with the AG to test innovative financial products or services within the RSP, and a separate application must be filed for each innovation sought to be tested.

The participant will have 24 months after it is approved for entry into the RSP to test the innovative financial product or service described in its application. RSP participants may make consumer lender loans (up to $15,000 per individual loan and $50,000 per consumer) or provide products or services as a money transmitter (up to $2,500 per transaction and $25,000 per consumer). Not more than 10,000 consumers will be permitted to transact through or enter into an

agreement to use the innovation unless the RSP participant demonstrates adequate financial capitalization, risk management process and management oversight, in which case the AG may permit RSP participants to allow up to 17,500 consumers to transact through or enter into an agreement to use the innovation. At least 30 days before the end of the 24-month RSP testing period, the RSP participant must notify the AG that the RSP participant will exit the RSP, wind down operations and cease offering any innovative products or services, or to seek an extension to pursue applicable licensure or authorization as required by law. If a test includes offering products or services that require ongoing duties, such as loan servicing, the RSP participant will be required to continue to fulfill those duties or arrange for another person to fulfill them after they exit the RSP. The RSP program will terminate on 7-01-2028.

Limited Liability Company Revisions (SB 1353)
The Arizona Legislature has adopted the Uniform Limited Liability Company Act (2013), which makes a large number of changes (some of which are fairly substantive, and all of which are beyond the scope of this legislative update) to the 1992 statute that currently governs limited liability companies formed or qualified in Arizona. The new Act will apply to LLCs formed, converted or domesticated in Arizona after 8-31-2019, unless the LLC elects to subject itself to those requirements prior to that date. The requirements of the new Act will apply to all LLCs formed and foreign LLCs qualified in Arizona after 8-31-2020 (at which time Arizona's current LLC statute will be repealed). The adoption of the new Act does not affect the validity or enforceability of a current and valid operating agreement.

GPLET Leases (HB 2126)
Arizona's GPLET statute (A.R.S. §§ 42-6201 et seq.) allows a city, town, county or county stadium district (called a "**Government Lessor**") to acquire title to land and improvements in a redevelopment area and/or a central business district ("**CBD**") of a city or town. The land and improvements are exempt from property taxes while the Government Lessor owns them, and the Government Lessor then leases them back to the developer (called a "**Prime Lessee**"), which then pays a significantly reduced "Government Property Lease Excise Tax" instead of paying ad valorem real property taxes. The property would typically qualify for an eight-year tax abatement, followed by a reduced or abated tax obligation (which could extend up to a total 25 years prior to the 2017 amendments described below). Many of the high-rise buildings in downtown Phoenix (including the one in which my office is located) are or have been GPLET lease projects. (Tempe is the next largest user of GPLET leases.)

In response to perceived misuse of the GPLET statutes, the Legislature amended the statutes in 2010 to increase GPLET rates for new leases entered into or on 6-01-2010[1], and required the Arizona Department of Revenue ("**DOR**"), beginning 12-01-2011, to annually adjust the GPLET rates for inflation for each type of property use, and to post the adjusted rates on the DOR's official website. The duration of GPLET leases was also reduced from 99 years to 25 years (including the abatement period).

The 2017 amendments to the GPLET statutes were introduced due to a 2015 Auditor General's report that found widespread miscalculation and underpayment or (non-payment) of GPLET [prior to the 2017 amendments, the Prime Lessee calculated the tax] and a significant loss of property tax revenues to elementary and secondary school districts caused by taking GPLET properties off the tax rolls (leaving other taxpayers to pick up the tab for the difference).

The 2017 GPLET amendments established a number of new restrictions:

1. A lease of a government property improvement entered into within ten years of an authorizing development agreement, ordinance or resolution that was approved by the governing body of the Government Lessor before 6-01-2010 is subject to the original GPLET rates, provided that the lease was deemed compliant by the DOR. The foregoing conditions were designed to prevent developers from resurrecting very old redevelopment agreements that were negotiated under much older versions of the GPLET statute.
2. The Government Lessor was required to maintain a public database, or post its lease agreements on a government website where the government property improvement is located, of all government property leases that are subject to GPLET. The 2015 Auditor General's Report indicated that many GPLET leases were not being reported to County Treasurers as required.
3. The DOR was required to place links to all of the Government Lessors' databases with active leases on the DOR website.
4. The Government Lessor (rather than the Prime Lessee) must calculate the excise tax for each prime lease. According to the 2015 Auditor General's report, GPLET liabilities calculated by Prime Lessees were almost always underpaid.
5. The lease period for which the GPLET is abated is limited to *eight years* after a certificate of occupancy is issued on the government property improvement, regardless of whether the lease is transferred or conveyed to subsequent Prime Lessees during that period.
6. The Government Lessor must convey the title to the government property and the underlying land to the current Prime Lessee within 12 months after expiration of the lease (unless the parcel is controlled by an airport subject to federal regulation or by the local federal transit authority).
7. The conveyed government property cannot qualify for classification as a Class 6 property or any other discounted assessment, regardless of its location or condition.
8. The limitations in paragraphs 5, 6 and 7 above did not apply to leases or development agreements for the lease of government property if *either* of the following occurred *before* 1-01-2017:
   (a) A corresponding resolution, ordinance or submitted request for proposal of the lease or intent to lease such property was approved by the governing body of the Government Lessor; or
   (b) A proposal was submitted to the Government Lessor in response to a request for proposals.
9. The improvement is located in a single CBD [a single and contiguous geographical area designated by resolution of the governing body of the city or town that is (a) located entirely within a slum or blighted area established under A.R.S. § 36-1471 et seq., and (b) geographically compact and no larger than the greater of 5% of the total land area within the exterior boundaries of the city or town or 640 acres].

HB 2126 was introduced and enacted in 2018 to impose a number of additional restrictions on GPLET projects (in particular affecting A.R.S. § 42-6209):

1. The size of a *central business district* [see paragraph 9 above] for a city or town is limited to the *greatest* of: (a) the existing total land area of the CBD as of 1-01-2018; (b) 2.5% of the total land area within the exterior boundaries of the city or town; or (c) 960 acres.
2. *Geographically compact* [see paragraph 9 above] means a form or shape that has a length of not more than twice its width as measured from at least four points on the exterior boundary of the expanded areas of an existing CBD or a newly formed CBD that is formed on or after 1-01-2018 [any CBD formed before 1-01-2018 is considered to be geographically compact if not further expanded].
3. The designation of a slum or blighted area in which a CBD is located that is made after 9-30-2018 will automatically terminate after ten years, unless formally renewed or modified in whole or in part by the city or town.
4. Before the tenth anniversary of its designation, a city or town is required to review a slum or blighted area designated on or after 9-30-2018 and in which a CBD is located and to renew, modify or terminate the designation following such review. If a city or town renews or modifies the original designation, it must conduct subsequent reviews every ten years thereafter. The designation will automatically terminate five years after review if a city or town fails to review or modify the designation.
5. On or before 10-01-2020, each city or town must review each slum or blighted area originally designated before 9-30-2018 and in which a CBD is located and either review, modify or terminate the designation pursuant to the review. If modification or review of the original slum or blighted area designation occurs, subsequent reviews must occur every ten years. If a city or town fails to renew or modify the designation, then the designation will automatically terminate on 10-01-2025 or five years after any subsequent review.
6. Government property leases or lease development agreements that meet either of the following conditions are not subject to the termination requirements in paragraphs 4 or 5 above:
   (a) The lease of the government property improvement was entered into before the termination or modification of the slum or blighted area designation; or
   (b) A development agreement, ordinance or resolution was approved by the governing body of the Government Lessor before the termination or modification of the slum or blighted area designation that authorized a lease on the occurrence of specified conditions and the lease was entered into within five years after the date that the development agreement was entered into or the lease or resolution was approved by the governing body.

State Land Department Renewal (HB 2017)
The Arizona State Land Department (**ASLD**) oversees 9.2 million acres of State trust land and the natural products derived from the trust land. The ASLD's purpose is to manage the trust land and maximize revenues for its beneficiaries, including K-12 schools. The ASLD was scheduled to sunset on 7-01-2018 unless continued by the Legislature. HB 2017 will, retroactively to 7-01-2018, continue the ASLD until 7-01-2026, and repeal the ASLD on 1-01-2027. The ASLD must present to the Legislature an update to its strategic plan on or before 7-01-2022.

Property Tax Appeals (HB 2385)
Current Arizona law allows a property owner who believes its property has been valued too highly for property tax purposes to appeal the valuation administratively (by petition to the County Assessor) or judicially (to the Superior Court). Only the *full cash value* (**FCV**) of the property may be appealed. (FCV is defined by statute, and is generally synonymous with market value as determined by standard appraisal methods and techniques.)

If the property owner appeals administratively and the County Assessor denies the request, the owner may appeal to the county board of equalization (or, if a county board does not exist, the state board of equalization) or to a Superior Court. Alternatively, an owner may bypass the administrative appeal process and appeal directly the Superior Court. The court may determine the FCV of a property to be higher or lower than the FCV that the property owner appealed. HB 2385 prohibits the Superior Court from determining that the FCV in a property tax appeal was greater than the amount appealed by the property owner.

Trust Instruments (SB 1204)
Current Arizona law allows one to include in a will or trust instrument a penalty clause to discourage beneficiaries, heirs or devisees from contesting the will or trust instrument. SB 1204 provides that such a penalty clause is unenforceable if probable cause exists for the contest.

Current Arizona law (A.R.S. § 14-10506) allows a creditor or assignee of a trust beneficiary to reach a *mandatory distribution* of income or principal if the trustee has not made the distribution to the beneficiary within a reasonable period of time after the mandated distribution date, even if the trust contains a spendthrift provision, unless the terms of the trust expressly authorize the trustee to delay the distribution to protect the beneficiary's interest in the distribution. *Mandatory distribution* means a distribution of income or principal, that the trustee is required to make to a beneficiary under the terms of the trust, including a distribution on termination of the trust; SB 1204 expands the definition of *mandatory distribution* to include a distribution amount for a stated age and a distribution made pursuant to the exercise of a power of withdrawal.

Current Arizona law (A.R.S. § 14-11013) allows a trustee to furnish a certification of trust, rather than a copy of the trust instrument, to a person other than a beneficiary. A recipient of a certification of trust may require the trustee to furnish copies of trust instrument excerpts designating the trustee and conferring on the trustee the power to act in a pending transaction [S.B. 1204 now requires that any such request be made in good faith]. A person who acts in reliance on a certification of trust without actual knowledge that any representations contained in the certification are incorrect is not liable to any other person for so acting and may assume without inquiry the existence of the facts contained in the certification of trust. (Actual knowledge of trust terms cannot be inferred solely from the fact that the person relying on the certification also has a copy of all or part of the trust instrument.) SB 1204 now prohibits any

person from requiring the trustee to furnish copies of trust instrument excerpts that contain dispositive terms of the trust or provisions on named successor trustees unless the person first provides the trustee with a verified statement that sets forth a reasonable basis for the request. A person making a demand for the trust instrument or excerpts from the trust instrument in addition to the certification of trust is liable for damages if a court determines the person did not act in good faith or otherwise comply with statutory requirements.

Condominium Termination Appraisals (HB 2262)
Except in the case of eminent domain, a condominium may be terminated only by an agreement of unit holders with at least 80% of the collective votes in the condo association (see A.R.S. § 33-1228). The condo termination agreement may provide that all common elements and condominium units must be sold following termination. Upon approval of unit owners, the association may contract to sell the real estate in the condominium, and proceeds from the sale are to be distributed to unit owners and lienholders in proportion to their respective interests as described in the statute.

The current statute provides that: (a) the respective interests of unit owners include the fair market values of their units, limited common elements and common element interests, immediately before termination as determined by an independent appraiser selected by the owners association; and (b) the independent appraiser's determination of value is final unless disapproved within 30 days after distribution by unit owners holding at least 50% of the collective votes in the association.

HB 2262: (i) requires the owners association to select an independent appraiser to determine the total fair market values of units, limited common elements and common element interests before the termination (and an additional 5% of that total amount for relocation costs for owner-occupied units); and (ii) allows *any* unit owner (rather than only unit owners having 50% of the collective votes in the association) to object to the association's appraisal within 60 days (instead of 30 days). HB 2262 permits a second independent appraisal to be performed at any unit owner's expense, and if that appraisal differs from the association's appraisal by 5% or less, the higher appraisal will be final. However, if the second appraisal is more than 5% greater than the association's appraisal, the unit owner must submit to arbitration at the association's expense to determine the final sale amount (with an additional 5% increment added for relocation costs for owner-occupied units). HB 2262 prospectively voids as a matter of public policy the provisions of any condo declaration that conflict with the foregoing provisions.

Transaction Privilege Taxes – Prime Contracting Classification (SB 1409)
The business of *prime contracting* for Arizona transaction privilege tax purposes (see A.R.S. § 42-5075) includes the supervision, performance or coordination of modifications of a building, road, excavation or other structure project, development or improvement, including contracting with any subcontractors or specialty contractors who are responsible for the completion of the contract. The gross proceeds or income derived from a contract with the owner of real property or improvements to real property for the maintenance, repair, replacement or alteration of existing property are generally *not* subject to transaction privilege tax. Current law defines an *alteration* as an activity or action that causes a direct physical change to existing property. However, alterations can currently be classified as prime contracting if (i) the contract amount is more than $750,000, (ii) the scope of work for the alteration project directly relates to more than 40% of the existing square footage of the existing property, or (iii) the alteration project expands the square footage of the property by more than 10% of the existing property.

SB 1409 specifies that prime contracting does *not* include any work or operations performed by a person that is not required to be licensed by the Registrar of Contractors, and removes the limitations referenced in clauses (ii) and (iii) above on the "alteration" exemption from the prime contracting classification. SB 1409 will become effective on 1-01-2019, but contracts entered into prior to that date are to be treated consistently with current law.

Contractor Licensing (SB 1375)
The Arizona Registrar of Contractors (**ROC**) issues contractor licenses. Applicants or licensees must identify, among other things, the names and addresses of partners of any partnership and officers and directors of any corporation, and must identify the owners of 25% or more of the stock or beneficial interest in the entity [see A.R.S. § 32-1122(B)].

SB 1375 requires an LLC applying for a contractor's license to include information relating to LLC managers and members and requires notice to be given to the ROC when any entity that is a licensed contractor transfers 25% (previously 50%) or more of the beneficial interest in the entity.

Recording Fees (SB 1043)
Current Arizona law (A.R.S. § 11-475) allows the County Recorder to collect a recording fee of $5.00 for the first five pages and $1.00 for each additional page of a recorded document. Additional fees are authorized for indexing categories, assignments and releases, and the county board of supervisors may assess a special $4.00 recording surcharge. In 2015, the Legislature enacted a standard $15.00 recording fee for each deed that transfers, conveys or affects an interest in real property, $25.00 for each deed of trust or mortgage, and $10.00 for each release of a deed of trust or mortgage. Beginning on 7-01-2019, SB 1043 establishes a flat fee of $30.00 per recorded instrument, which includes any additional charges or surcharges described in the preceding sentences that are now are separately charged.

Real Estate Licenses (HB 2655)
Current Arizona law (A.R.S. §§ 32-2101, 32-2124, 32-2132, 32-2135 and 32-2163) requires an initial applicant for a real estate salesperson or broker license to complete at least 90 classroom hours in a real estate school certified by the ADRE Commissioner and pass required examinations. A renewal applicant must file an application and show evidence of continuing education attendance (24 credit hours for a salesperson or associate broker and 30 credit hours for a designated broker or associate broker employed by the designated broker) at a school certified by the ADRE Commissioner during every 24-month period of licensure (A.R.S. § 32-2130). Current licensees may also attend "distance learning courses" over the internet.

HB 2655 permits an *initial applicant* for a real estate salesperson or broker license to take *online courses* (real-time interaction with the instructor is not required and a platform may be used that allows the student to proceed at his or her own pace) offered by a school certified by the ADRE Commissioner if all exams are taken in person. An application for a certificate of online course approval must be submitted to ADRE 90 days before holding an online course or study, and ADRE must approve or disapprove the course within 90 days after receiving the application.

Arizona Department of Financial Institutions Application Fees (SB 1150)
The application fees charged by the ADFI for banking permits, trust company licenses, commercial mortgage banker and mortgage banker licenses, and commercial mortgage broker and mortgage broker licenses will be significantly reduced, as will the fees to convert from federal to state chartered thrift institutions.

Construction Liability Apportionment Study Committee (SB 1271)
SB 1271 establishes a Construction Liability Apportionment Study Committee (three members from the State Senate and three members from the State House) to research and make recommendations for the apportionment of liability in the construction industry, including: (a) the use of an indemnity provision in construction contracts; (b) the allocation of liability based on degrees of fault; (c) the assignment of financial responsibility to negligent parties; (d) the opportunity to address and remedy alleged construction defects prior to litigation; (e) the frequency of construction defect litigation; and (f) the affordability of insurance costs associated with construction claims. The Study Committee is to submit its findings and recommendations to the Governor and Legislature by 12-15-2018.

Native American Day (SB 1235)
California, Nevada and South Dakota have declared Native American Day an official state holiday [but it doesn't fall on the same date in each of those states]. Tennessee has also declared American Indian Day as a holiday. SB 1235 establishes June 2 of each year as Native American Day and adds it to the statutory list of Arizona holidays. If Native American Day falls on a day other than Sunday, it will be observed on the Sunday following June 2 (i.e., it is not a paid state holiday). This additional holiday should therefore not affect the conduct of business if June 2 falls on a business day.

General Effective Date
New 2018 legislation has a general effective date of **August 3, 2018**.

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[1]Unlike regular property taxes, which are based on property value, GPLET rates are based on the size and type of the leased buildings. The pre-2010 GPLET taxing structure resulted in a GPLET liability of roughly 40% of the probable ad valorem property tax liability for a property located within a redevelopment area, and 60% of the probable ad valorem property tax liability for a property outside of a redevelopment area. The 2010 amendments resulted in a GPLET liability of roughly 60% of the probable ad valorem property tax liability for a property within a redevelopment area, and roughly 90% of the probable ad valorem property tax liability for a property located outside of a redevelopment area. The 2010 amendments also eliminated the automatic reduction in GPLET rates that had been provided to older buildings, and, beginning in 2012, allowed the DOR to adjust GPLET rates annually based on changes in the U.S. Bureau of Labor Statistics' producer price index for new construction for the prior two fiscal years. The 2015 Auditor General's report referenced above found that very few GPLET projects were paying taxes at post-2010 rates.

About the Author:
Michael P. Ripp has been with Ryely Carlock & Applewhite since 1986 and heads up the Phoenix office's banking and finance practice. For 33 years Mike has represented lending institutions and borrowers in commercial real estate and asset-based (including agricultural) loan transactions (including loan originations, workouts and enforcement) and real estate purchases and sales. Mike can be reached at 602.440.4823 and mripp@rcalaw.com.

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