



Flynn-Law Newsletter

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Downtown Napa Office Opening Soon!

I am very pleased to announce that my offices, presently in San Francisco, will be moving to downtown Napa, California.

In December, we closed on a historic Victorian home which was previously converted into an office building. Currently, we are in the process of a major remodel and upgrade of the property to return it to a larger and more contemporary version of its former glory.

Barring any unforeseen developments, I hope to relocate to the Napa office in two months. If you or anyone you know might be interested in renting space in the building, please let me know. The ideal candidate would be a solo professional, such as a CPA, engineer or financial planner. There are 6 office spaces available for rental, with two conference rooms, a reception area and a kitchen.

In the meantime, please continue to use my current address and phone number. You can see some pre-renovation pictures on pages 2 and 3.

GVLA v. Vallejo Update

The First District Court of Appeals' decision in *Green Valley Landowners Association v. City of Vallejo*, (2015) 241 Cal.App.4th 425 (Case No. A142808, filed Oct. 16, 2015, certified for publication) has major adverse ramifications for all 121 charter cities in California, as well as the class of 809 non-resident customers who receive water from Vallejo's historic "Lakes Water System."

The issue in *Green Valley* was whether the general laws of the State of California are *binding* upon a charter city in a matter of municipal affairs in the absence of a contrary charter provision or municipal ordinance.

The answer should have been clear. In the 1800's and early 1900's, courts routinely subjugated charter city laws and actions to the general laws of the State. In 1914, the California Constitution was amended for the express purpose of granting charter cities complete independence of the State's general laws, at least with respect to matters of municipal concern.

This amendment, known as municipal "home rule", and is codified in

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"The issue in Green Valley was whether the general laws of the State of California are binding upon a charter city in a matter of municipal affairs in the absence of a contrary charter provision or municipal ordinance."

High Volatility Commercial Real Estate Loan Rules

On January 1, 2015, the final Basel III rules took effect. They impose new requirements on banks for high volatility commercial real estate (HVCRE) loans, meaning loans for the acquisition, development or construction (ADC) of commercial real property.

If a loan is considered HVCRE, lenders will need to assign a 150 risk weighing to the loan, as opposed to a traditional 100 risk weighing, making the loan more expensive.

A commercial real estate ADC loan may avoid HVCRE classification if:

1. Certain loan-to-value (LTV) ratios are satisfied (65% for raw land and 75% for land development); and
2. The borrower contributes capital in the form of cash or readily marketable assets of at least 15% of the project's "as completed" appraised value (as opposed to the total project cost).

The bottom line is -- the HVCRE rules make it more expensive (but not impossible) for commercial borrowers to get development loans when they are relying primarily on appreciated land values for equity. Borrowers will need to either contribute cash equal to 15% of the as-completed cost, or they will need to pay for a more expensive loan.

The U.S. Federal Banking Agency has issued 17 "frequently asked questions" about how to apply the HVCRE test. It is clear that the appreciated value of land will not count toward the 15% capital requirement.

Under FAQ #7, if cash is used to purchase land, and that land is subsequently contributed to an ADC project, the cash paid will count toward the 15% capital requirement. Thus, if you buy land with cash, and shortly thereafter get a loan, the cash paid for the land will meet the 15% requirement.

Under the FAQ's, it is unclear whether the initial purchase price would or would not count toward that requirement as the FAQ's do not address this hypothetical. Therefore, if land was purchased for \$100,000 ten years ago, but is now worth \$500,000, would \$100,000 count toward the 15% requirement? Under a strict reading of the rule, land purchased years ago does not appear to meet the definition of "cash" being contributed to the ADC project.

Under the new HVCRE rules, there are not any changes in how the LTV is calculated. In other words, there is not anything which prohibits the current value of appreciated land to be used in calculating the LTV. Thus, in the prior example, the full \$500,000 would count in determining the project's total value, even if the appreciated amount would not count toward the 15% test.

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A pre-renovation picture of the new downtown Napa office. After a new foundation is put in place, a new ground floor and front porch will be added, in addition to extensive interior remodels.

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Article XI, Sec. 5 of the California Constitution. It provides:

Cities . . . organized under charters . . . are . . . empowered . . . to make and enforce all laws and regulations in respect to municipal affairs, *subject only to restrictions and limitations provided in their several charters* and in respect to other matters¹ they shall be subject to and controlled by general laws (italics added).

The *Green Valley* decision fundamentally undercuts municipal home rule as it has existed for 101 years. In *Green Valley*, the Green Valley Landowners Association, acting as the lead plaintiff in a putative class action against the City of Vallejo, alleged that Vallejo breached implied-in-fact contracts with 810 non-resident water customers of Vallejo’s historic “Lakes Water System.”

As the Court of Appeal correctly observed, Vallejo’s charter does not require a written contract, nor does it have a single ordinance requiring a written contract. The Court of Appeal also correctly observed that the manner and mode of entering into a contract is unquestionably a municipal affair. From these undisputed conclusions, under the home rule doctrine, Vallejo may enter into a contract in any matter it chooses, free from any interference from the general laws of the State.

The Court of Appeal disagreed, holding that Government Code §40602, a general law statute which purportedly requires a written contract, is binding on the City. Relying on dicta from the obscure case of *McLeod v. Board of Pension Commissioners* (1970) 14 Cal.App.3d 23, 29-30, the Court of Appeal held that “If a city’s charter is silent as to a particular matter, even one concerning a municipal affair, . . . the matter will be subject to the general laws of this state.”

In support of its reasoning, the Court of Appeal relied upon *Civil Center Assn. v. Railroad Comm.* (1917) 175 Cal. 441, a decision which was interpreting the pre-1914 version of the California Constitution. The Court of Appeal also relied upon *Hyde v. Wilde* (1921) 51 Cal.App. 82, a case where the charter of San Diego (at the time) expressly provided that the general laws of the state would apply to a particular matter of municipal concern.

Regardless of the outcome in the *Green Valley* case, every charter city in the State should be alarmed by this decision. Any attorney representing a charter city would wisely advise their client to dramatically expand the scope of their charters and ordinances to cover every conceivable topic concerning all municipal affairs. Their failure to do so, under *Green Valley*, subjects them to the general laws of the state.

The Green Valley Landowners Association has petitioned the California Supreme Court for review. (See, <http://www.smflynn-law.com/documents.html>, Doc. #12). We welcome amicus letters urging the Supreme Court to accept the petition. We expect a decision as to whether the Supreme Court will accept the case in February or March 2016.



The new downtown Napa office building, 1 week into the foundation replacement.

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HVCRE Rules, from page 2

If additional cash were needed, it seems possible that you might be able to get a loan on another property and use those proceeds to meet the 15% test. FAQ 16 provides:

“If a banking organization lends a borrower 15 percent against the property, independent of the project, can the proceeds from the loan count towards the obligor’s 15 percent capital contribution to the project? No. Proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount.”

Life Insurance Funded Redemption Procedures for S-Corps

Key-man life insurance can be used to redeem a deceased shareholder in a small business corporation (“S-Corp”). Using the procedures below, the proceeds from the insurance policy can be used to increase the basis of the remaining shareholders.

Since the deceased shareholder automatically gets a step up in basis, the key is to redeem the deceased shareholder’s interest before applying for the life insurance proceeds. That way, the income from the life insurance proceeds can be allocated 100% to the remaining shareholders, increasing their inside basis in the company.

Flynn-Law Press

- Local Landowners Seek to Take Water Lawsuit to Supreme Court. The Reporter.
<http://www.thereporter.com/article/NG/20151023/NEWS/151029931>
- Landowners Want State Supreme Court to Hear Solano Water Case. Daily Republic.
<http://www.dailyrepublic.com/news/solanocounty/landowners-want-state-supreme-court-to-hear-solano-water-case/>

Life Insurance Redemption Procedures from page 4

Step 1. Upon the death of the shareholder, his or her interest should be fully redeemed by the issuance of a note (or notes) equal to the buy-out price. If the buy-out price exceeds the proceeds of the insurance policy, a second note should be issued.

Step 2. After the shareholder’s interest has been completely redeemed, the corporation should file an election under Section 1377(a)(2) of the Internal Revenue Code to terminate their tax year.

Step 3. Only after redeeming the shareholder and terminating the S-Corp’s tax year, should the corporation apply for the proceeds from the life insurance policy.

Step 4. The proceeds from the policy will be used to repay the note to the deceased shareholder in full.

If structured in this manner, the income from the proceeds will be allocated 100% to the remaining shareholders, avoiding a wasted allocation of basis to the deceased shareholder (who already has a step up in basis).

If the proceeds from the life insurance policy are insufficient, the company may either issue a second note, as discussed earlier, or may pay the balance of the buy-out in cash.



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