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CONTENTS

REAL ESTATE WORKOUTS:
CASH FLOW MORTGAGES

By Wing Leung

Thankfully, not all commercial properties are underwater or over-levered; however, even properties with relatively low loan-to-value ratios may experience extended bouts of cash shortfalls. A borrower failing to meet its debt-service obligations under existing commercial mortgage terms may negotiate with the lender to modify the loan to a cash flow mortgage. With a cash flow mortgage, the borrower's debt service obligation at any point during the loan term is measured by the availability of cash flow at that time. The scenario that most often calls for a cash flow mortgage is a property *temporarily* in distress such as a property with a large tenant vacating space and there are reasonable expectations to re-lease the space for comparable or higher rents. In this situation, a lender with an outstanding mortgage loan likely to be defaulted may be willing to convert to a cash flow mortgage rather than foreclose or take a deed in lieu of foreclosure. Alternatively, the owner of a distressed property may be able to sell it for a price somewhat above the amount of the existing mortgage, with the seller taking back a purchase money cash flow mortgage in lieu of cash.

Commonly, loan agreements permit a lender to control the property's cash receipts and disbursements if minimum debt service coverage ratios or other financial covenants are not met. The priority of payment varies between making operating expenditures, paying debt service, paying subordinate debt, or funding reserve accounts based on terms of the loan agreement. In some cases, operating expenditures are subordinate to debt service payments, resulting in inability to pay operating expenses, thereby adversely affecting the property's upkeep and tenants. A lengthy postponement of repairs or replacements solely in order to meet current debt service is detrimental to the property, its tenants and possibly its neighbors. Formal loan modifications can reset the priority of

▶ Read more on page 6

LEASES:

THE TAKEOVER LEASE

by David Tevlin

WHEN OFFICE BUILDING VACANCIES ARE HIGH, AS NOW, LANDLORDS ARE LIKELY TO USE EVERY MEANS WITHIN THE LAW TO ATTRACT TENANTS FROM OTHER PROPERTIES. IN ONE TECHNIQUE, THE TAKEOVER LEASE, AN EXISTING TENANT IS INDUCED TO SIGN A LEASE IN ANOTHER BUILDING BECAUSE OF THE NEW LANDLORD'S PROMISE TO TAKE OVER THE EXISTING LEASE, I.E., ASSUME LIABILITY UNDER THE OLD LEASE FOR THE BALANCE OF THE TERM. THE TENANT'S ONLY CONCERN IS THAT ITS OBLIGATIONS NOT BE INCREASED BECAUSE OF ANY ACTIONS BY THE SECOND LANDLORD.

▶NEW LANDLORD'S OBLIGATIONS

In a takeover situation, the new landlord should assume all obligations under the lease, including payment of any escalation or percentage rent payable in addition to the base rent. However, the new landlord should not be liable for any breaches of the lease by the tenant and should not have the obligation to restore the premises at the end of the term (since this would be the duty of the tenant whether or not the takeover occurred). The date of the takeover, i.e., the time when the second landlord's obligations begin, should be the later of (1) the date when the tenant vacates the old premises, or (2) the inception of the tenant's liability under the new lease.

▶LEGAL BARRIERS TO TAKEOVER

The first landlord's view of a takeover lease is that it constitutes a "raid" on his building. He may sue the second landlord on the ground that the action constitutes an improper interference with a lease relationship. However, as long as the second landlord has not misrepresented material facts (e.g., with regard to the safety of the building) or used coercive measures, but has acted only to further his own economic interests, the lawsuit is not likely to succeed. Another method available to the first landlord is to insert an "anti-raid" provision in the lease that bars the tenant from accepting a takeover offer. Such a provision might include an acknowledgment by the tenant that occupation of the premises is important to the landlord's successful operation of the building and the tenant's agreement that all future rent is to accelerate and become immediately payable if the tenant vacates the premises.

▶RIGHTS OF NEW LANDLORD

The take-over landlord should receive an up-to-date copy of the existing lease so that the precise obligations being assumed can be determined. If the takeover is in the form of a sublease, the tenant should agree to make no modification of the prime lease without the consent of the take-over landlord. The latter should have a free hand in dealing with the leasehold, i.e., he should be able to assign, modify, or surrender it, or sublet the premises. (All this assumes the lease permits this to be done without the consent of the first landlord.) If the take-over landlord is able to re-let the premises, he should be entitled to keep all of the rent, having assumed all of the obligations under lease.

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MORTGAGE LOANS: BUYING AND SELLING

By Anthony La Malfa

One fallout from the real estate crash is the development of market for the sale of existing mortgage loans. Banks and other lenders are motivated to sell troubled paper in order to avoid the time and expense of renegotiating or foreclosing loans. In particular, the sale of non-performing loans enables lenders to remove them from their books. This eliminates the need to tie up capital to satisfy risk-based capital requirements and maintains the lender's reputation in the marketplace.

Many investors, on the other hand, see opportunities in buying both performing and non-performing mortgages at substantial discounts. Investors intend to seek control of properties through foreclosure, restructure the loans on favorable terms, or securitize the loans for sale to the public. However, both parties in a sale of mortgages should be aware of the many legal and economic pitfalls in such purchases.

LENDER LIABILITY

One important concern for a lender is the potential liability arising from the disclosure of confidential information about the borrower. The "due diligence" obligation of the buyer often requires an inspection of the loan documentation. Generally speaking, the lender will not be liable for showing such documentation. However, it is often the case that the loan documents contain restrictions regarding the disclosure of confidential information (e.g., financial statements of borrowers or guarantors). In order to avoid liability, the lender should review the loan documents first to determine if any such restrictions exist. The lender also should require the prospective buyers to execute confidentiality statements and screen the buyers for interests adverse to the borrower.

SALE LIMITATIONS

In some loans, the lender is barred from selling the loan to a third party or the borrower has a right to arrange for the purchase of the loan. A sale inconsistent with such provisions opens the lender to potential liability. In particular, the lender should consider a possible contention by the borrower that there had been ongoing negotiations or a commitment to structure the loan when the sale to the third party was made. In such instances, the borrower may claim that the sale is in breach of an agreement to restructure, with resulting damage to the borrower. One way for a lender to avoid such a claim is to initially offer to sell the loan to the borrower (i.e., permit prepayment) on the same terms and conditions as would be offered to a third party.

FUTURE FUNDING OBLIGATIONS

Yet another consideration for the lender to consider is whether any obligations continue to bind the lender following sale of the loan. For example, a lender may continue to be bound by any future funding requirements set forth in the loan. In that event, the lender should be satisfied that the buyer can do the funding (and the lender may want to secure that obligation by a guarantee, indemnity, or other form of security). Alternatively, the lender may consider retaining the obligation for future funding and adjust the loan purchase price accordingly.

DUE DILIGENCE BY INVESTOR

Perhaps the most important concern from the investor's perspective is the availability of full information relating to the loan, including the loan documents, borrower profile information, and the condition of the real property. The investor should insist on access to all loan documents in addition to the note and mortgage, i.e., pledge agreements, guarantees, letters of credit, indemnification agreements, assignments of stock or partnership interests, and lockbox agreements. A variety of ancillary documentation also should be inspected, e.g., title policies and surveys, environmental reports, permits and licenses, and information about any threatened or pending lawsuits.

LOAN PURCHASE AGREEMENT

The critical document in the transaction is the loan purchase agreement that sets forth all the terms and conditions of the purchase. The clause covering the presentations and warranties to be given by the lender is likely to be heavily negotiated. At a minimum, the lender should represent its authority to enter into the agreement, that the loan has not already been sold and is not in default, and that no litigation is pending relating to the loan or the property. Additional representations might cover the priority of the mortgage or deed of trust, the absence of any defenses by the borrower, and the accuracy of information given to the purchaser.

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MORTGAGES:

BUYER CONTINGENCY CLAUSES

By John Tax

BECAUSE THE MAJORITY OF ESTATE BUYERS ARE NOT PREPARED TO PAY ALL CASH FOR A PROPERTY, A CONTRACT OF SALE FREQUENTLY INCLUDES A MORTGAGE-CONTINGENCY CLAUSE THAT PERMITS THE BUYER TO CANCEL THE CONTRACT IF A MORTGAGE COMMITMENT IS NOT OBTAINED WITHIN A DESIGNATED TIME PERIOD. UPON OBTAINING THE MORTGAGE, THE BUYER NO LONGER HAS THE RIGHT TO TERMINATE THE CONTRACT BECAUSE OF LACK OF FUNDS. HOWEVER, RISKS STILL EXIST FOR THE BUYER.

Merely obtaining a mortgage commitment does not guarantee the lender will make the loan and advance the funds at closing. The lender may refuse to make the loan even though the buyer is not at fault. For example, the standard mortgage commitment gives the lender the right to withdraw if there has been a "material adverse change" in the financial condition of the borrower or in the security to be given for the loan, such as a change resulting from a fire or other casualty. In addition, some lenders may issue commitments conditioned on the receipt of satisfactory appraisals and flood-zone certificates, or approval of existing leases or other matters that are within the discretion of the lender.

▶FIRE AND OTHER CASUALTIES

The most common commitment conditions relate to fires or other casualties. While the effect of such a casualty on the sale itself is likely to be covered in the contract, it usually is not mentioned in the context of the mortgage-contingency clause. Consequently, if the damage cannot be repaired before closing, the lender may elect not to fund the loan, leaving the buyer without financing. One solution is to provide that the buyer may terminate the contract if a casualty results in damages that exceed an agreed threshold amount.

▶PROTECTING THE BUYER

The best way to protect the buyer from the risk of commitment contingencies is to provide in the contract that the buyer can terminate the agreement without penalty if the lender does not actually make the loan (unless the cause is the buyer's default under the loan commitment). However, the seller may argue that he or she is entitled to some compensation for holding the property off the market during the contract period. One possible solution is for the seller keep the interest earned on the down payment or be paid a small amount equivalent to the fee that would have been charged if the buyer had been given an option to purchase. On the other hand, the seller should not be entitled to any payment if the reason for failure to fund the loan is due to the seller's inability or unwillingness to comply with reasonable requests of the lender.

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LOANS:

PREPAYMENT PENALTY UPHELD

By Alvin Arnold

The Colorado Court of Appeals ruled that a large loan prepayment penalty was enforceable and not unconscionable in the case of *Planned Pethood Plus v. Keycorp, Inc., 2010 WL 185414 (Colo. App.)*. Pethood is a veterinary clinic owned by two veterinarians. It obtained a commercial loan of $389,000 from Keybank at a fixed interest rate of 8.3 percent for a term of 10 years. The promissory note contained a clause, prominently displayed on the first page, allowing Pethood to prepay the loan in whole or part by paying the lender a penalty equal to (1) prepayment amount, (2) times the number of years remaining on the loan, (3) times 1-1/4 percent. After 16 months, Pethood prepaid the loan together with a prepayment penalty of $40,500. This represented a penalty of 10.7 percent of the principal balance. Pethood then began this suit. The trial court entered judgment in favor of Keybank and Pethood appealed.

NOT LIQUIDATED DAMAGES

Whether a prepayment penalty can be upheld as a form of liquidated damages was an issue of first impression in Colorado. The general rule is that when a breach of a loan contract occurs, a liquidated damages provision must be reasonable in light of the anticipated or actual loss caused by the breach. A liquidated damages provision must not be unreasonably large for the expected loss from a breach of contract. Said the court, "Even if Pethood is correct that the prepayment is unreasonable, it is not an unenforceable penalty under the law of liquidated damages because there was no breach of contract. Pethood exercised its right to prepay the loan, thereby triggering the prepayment penalty."

Where a borrower exercises an alternative form of performance by invoking a prepayment privilege the law of liquidated damages is inapplicable. Prepayment penalties are generally considered valid provisions for alternative performance rather than penalties or liquidated damages. Said the court, "Prepayment provisions simply grant borrowers the right to prepay the loan in exchange for paying the lender a fee.... Because the borrower retains control over the manner of performance, prepayment with a penalty is an alternative manner of performance, not liquidated damages."

UNCONSCIONABILITY

Pethood then argued that the prepayment penalty is nevertheless void on equitable grounds because it is unconscionable. The court disagreed. The court said that a penalty might be so large as to render its enforcement unconscionable and in such case a court has the equitable power to refuse to enforce it. However, the prepayment amount here was not unconscionable. In addition to being relatively small, the penalty clause was prominently displayed on the first page of the note, which the borrowers signed. In addition, the borrowers had previously negotiated for other commercial loans, two of which contained prepayment penalty clauses. The appellate court confirmed the ruling of the trial court.

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METROPOLIS:

FIVE NEW REALITIES

By Alvin Arnold

Real estate ultimately is about people; with how many they are and what their ages are; where they live; how they earn a living; how they spend their money; and how they are divided by race and ethnicity. The Brookings Institution, in a new report, titled "The State of Metropolitan America," discusses the five "new realities" that are on the front lines of demographic transformation. These are briefly described below.

GROWTH AND EXPANSION

The U.S. population passed 300 million and in the next decade an additional 28 million people will live here. The nation's large metro areas grew by a combined 10.5-percent in the past decade as compared to 5.8- growth in the rest of the country. At the same time, the metro areas continue to spread out and their less developed outer areas grew by more than three times the rate of the cities and inner suburbs.

POPULATION DIVERSIFICATION

The U.S. population now is one-third non-white and these groups are counted for 83 percent of population growth between 2000 and 2008. Nearly one-quarter of U.S. children have at least one immigrant parent. This coming-of-age generation, 30 years from now, will begin the transition to a majority non-white nation. Large metropolitan areas will get there first as their under-18 population has already reached majority non-white status by 2008.

AGING OF POPULATION

U.S. baby boomers and seniors now number more than 100 million. Large metro areas are experiencing a 45-percent increase in the 55-64-old population between 2000 and 2008. As a result, single person households are growing more rapidly as well, often in suburban communities not designed with these populations in mind.

EDUCATIONAL ATTAINMENT

More than one-third of U.S. adults held post-secondary degrees in 2008, up from one-quarter in 1990, helping to stimulate economic growth. However, younger adults, especially in large metro areas, are not achieving these same levels. Moreover, the African-American and Hispanic groups, who will make up a growing share of the future workforce, lag between white and Asian counterparts in large metro areas to a significant degree.

INCOME POLARIZATION

The typical American household saw its inflation adjusted income decline by more than $2,000 between 1999 and 2008. Low and middle wage workers lost considerable ground but high wage workers had earnings rise. Large metro areas stood at the vanguard of such troubling trends. By 2008, high wage workers in large metro areas out-earned low wage counterparts by a ratio of more than five to one, while the number of persons living in poverty had risen 15 percent since 2000.

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CONTINUED FROM PAGE 1

CASH FLOW MORTGAGES

payment and ensure adequate maintenance of the property and servicing of the tenants for awhile. Still, the required debt service payments would then fall short under an unmodified loan. Changing over to a cash flow mortgage results in a compliant loan.

A bank approving a loan modification will have one less non-performing loan or REO property on its balance sheet. The lender also avoids time and costs associated with the foreclosure process. This keeps the risks of ownership with the borrower and the lender or servicer avoids the need to monitor costs to ensure borrower is not deferring maintenance. Renegotiating the terms also provides opportunities for the lender to increase the interest rate and seek a partial loan pay-down and for the borrower to obtain advances for tenant improvement or releasing costs. A cash flow mortgage acts like a bridge loan without the borrower incurring the costs and inconvenience of seeking short-term financing. It also provides time for the borrower to stabilize the property and seek alternate longer-term financing. A revised loan also mitigates a borrower's going-concern issues. It also allows the underlying borrower to maintain its reputation, relationship with the lender, and credit history.

A CMBS note has multiple note-holders compared to a bank-held note. Therefore, a special servicer of a securitized note may be less inclined to modify a loan for fear of lawsuits from different tranche holders. Similarly, the senior CMBS tranche- holders may push for foreclosing and liquidating the property to ensure their return of capital and potentially squeezing out the junior tranche holders. A modified loan may yield a lower return to the lender or note-holder even if the cash flow mortgage is satisfied at maturity because the delayed interest and principal received adversely affect the rate of return. Net cash flow available for debt service under a cash flow mortgage may be lower than owning the property outright because of special expenses. Before both parties agree to the loan modification, they should also consider whether accounting issues in the transaction would result in the recognition of cancellation of indebtedness for income tax purposes.

Lenders also have to consider the recent Financial Accounting Standard Board's proposal to require banks to mark-to-market notes held on its balance sheet. These notes are recorded at amortized cost under current pronouncements. Borrowers should consider alternate financing, including hard-money lenders, as the credit markets have gained traction in the first quarter of 2010 and rates may be lower than that being offered for changing over to a cash flow mortgage.

This type of modification should not be mistaken for the widespread practice of "extend and pretend" wherein the lender or servicer extends a cash-flowing property's maturing loan that cannot be refinanced in the current state market. In such cases, the lender may only be delaying the inevitable and losses will eventually need to be recognized upon price discovery if commercial real estate prices, loan-to-values, and occupancy levels do not return to their pre-recession levels in the near-term.

Some finer points with respect to structuring a cash-flow mortgage include how to calculate cash flow. The negotiations will involve what constitutes revenue and deductions from revenues to arrive at cash flow. Revenues should include rents and other operating income on a cash basis rather than accrual. If capital proceeds are taken into account, revenues should be limited to net proceeds such as insurance proceeds reduced by casualty-repair charges. Some lenders may require that revenues be increased to reflect market rents when space in the building has been leased at below-market rates, particularly to the borrower's related entities. Expenditures in connection with the ownership, operation, repair and maintenance and use of the property should be deducted from revenue in the cash flow calculation. However, the difference in legalese between "necessary and customary" and "reasonable" could result in drastically different deductions. Further, the borrower will want to deduct the cost of certain maintenance and capital expenditures, such as tenant improvements and replacements, and commissions.

To the extent cash flow is insufficient to pay the entire interest due, the unpaid interest is deferred. If cash flow at any point is above current-due interest, the excess is typically applied to past-due interest. Some items to consider when structuring the mortgage include whether deferred interest will itself accrue interest. Also, is deferred interest treated as an addition to principal? If so, interest will increase at each future installment based on higher principal balances. The lender may desire to limit the deferral period or permit deferral of interest until the maturity of the loan.

Delinquencies continue to burgeon. The CMBS delinquency rate was 8.42 percent in May, up 40 basis points from the previous month and 565 basis points from a year ago, with lodging and multifamily sectors leading the way at 18.45 percent and 13.34 percent, respectively, according to Trepp LLC, a real estate research firm. Similarly, Foresight Analytics, a division of Trepp, estimates first quarter 2010 delinquency rate for U.S. bank and thrift-held commercial mortgages at 5.5 percent, up from 5.1 percent for the previous quarter. As such, the most difficult part for a borrower attempting to modify a note may actually be getting the attention of an already swamped lender or special servicer.

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