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Real Estate Monitor

Purchase and Sale:

Flawed Properties1

Leases:

Terminating a Retail Lease with
Defensive Closures.....2

Refinancing:

Property Under Pressure3

Investments:

Land Purchase Leasebacks4

Development:

Vested Rights Doctrine5

The United States:

Demographic Trends6

Purchase and Sale:

Flawed Properties

By John Tax

Income producing properties put up for sale are never perfect. In a seller's market, buyers can do little about existing flaws so they rarely are a significant impediment to a closing. In a buyer's market, such as at present, the seller may find it necessary to deal with such flaws in order to close the transaction. A "flaw" in this sense is considered a remediable condition that does not create any permanent impairment to the property. For example, a basically sound shopping center might have vacancies, might require major roofing repairs or have key tenants with short remaining terms. In such situations, the reluctant buyer may have second thoughts about the purchase. The seller's response can be any one of the following:

- Correct the problems prior to the sale,
- Agree to correct the problems subsequent to the sale,
- Reduce the purchase price, or
- Structure the sale in one of the ways described below.

Conditional Sale

The traditional two-stage method of transferring property, i.e., the contract to sell and subsequent closing, means that provisions can be made in the contract of sale to release either party from obligations. Most often, these conditions are of concern to the purchaser, such as the need to obtain a zoning change or a mortgage commitment. In addition, the buyer can specify that if some standard or property operation is not met at the time of the closing, the contract can be terminated. In addition, the buyer may insist on reimbursement of certain costs in the event the sale cannot be consummated.

Surviving Warranties

Perhaps the most common technique for compensating for a property deficiency is for the seller to warrant a particular fact will endure for a specified period. For example, the seller may warrant that gross rental income from the property will not be less than a specified amount for a specified period. This is the best protection for the purchaser since it applies to both predictable and

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non-predictable occurrences. The seller must bear the cost whenever the target result is not reached, even if the failure is due to conditions arising after the sale or due to the buyer's own actions. In some cases, the flaw in the property may be specific, i.e., the risk that a key tenant may not renew a lease. Here, the risk to the seller is not open-ended, and so minimizes the seller's risk.

Limitations to Warranties

A seller may be agreeable to a warranty in the event of a flaw, so long as no cash reimbursement will be required. This is possible whenever a purchase money mortgage is given in the sale. A reduction of the purchase price then can be effected by reducing required payments under the mortgage. For example, the mortgage balance can be reduced by capitalizing the diminished cash flows, or the debt service can be reduced by the shortfall of the diminished cash flow, thus lengthening the mortgage term or creating a balloon, or the debt service can be made to fluctuate with the cash flow.

Space Leaseback

In a weak economy, vacant space is common. The seller of a retail property with vacant space may be willing to lease back all or some of the space at an agreed rental until a new tenant is found. Similarly, if one or more leases are due to expire shortly and there is doubt as to renewal of the space or in a new tenancy, a space leaseback can be a temporary solution to this flaw in the transaction.

Conditional Mortgage

While real estate mortgages are generally viewed as fixed instruments, this is not always the case. A mort-

gage's principal amount, interest, debt service, maturity or collateral all may vary. For example, an "income mortgage" can provide that debt service is payable only to the extent of income actually derived from the property, with the unpaid debt service deferred or waived. The income mortgage at one time was a popular alternative to the partial moratorium for a troubled property. For example, the buyer of a shopping center may be concerned that the key tenant's percentage rent will decline below a certain point. The parties then can provide that the debt service on the mortgage will be payable only to the extent of the percentage rent actually received, with the unpaid interest either accrued or even waived. If after some time period, the percentage rent fails to meet expectations, the mortgage principal (i.e., the effective sales price) will be reduced.

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Leases: Terminating a Retail Lease with Defensive Closures

By Wing Leung

In recent months we have witnessed landlord and retailer disruption caused by bankruptcy, foreclosures and slow sales. In an uncertain economic climate, negotiating a retail lease by both landlord and tenant calls for additional thinking about what may happen if either party runs into problems down the road. In particular, each party must decide under which circumstances the lease can be terminated because of the failure of the other party to meet specified requirements.

Preparing Space

Depending on which party will prepare the space for occupancy, the other party will want a right to terminate the lease if the plans and specifications are disapproved or construction is significantly delayed, resulting in either lengthy downtime for the landlord or encumbered tenant resources. In most cases, the tenant is the one that must submit plans and specifications to the landlord for approval to ensure the buildout is consistent with the theme of the facility and that the plans do not adversely affect another tenant. When a new building is being constructed or major renovations are to occur, it may be the landlord who must submit plans and specifications to the tenant for approval. In the case of a shopping center, a key tenant may have reserved the right to approve new tenants, in which case the approval of the tenant may also be necessary. In all of these situations, it should be clear that the failure to receive approval from a necessary party will result in a termination of the lease without penalty to either party.

Percentage Rentals

The use of percentage rentals and the related right of the landlord to terminate the lease if the rentals are below a specified level has become almost standard usage because it satisfies a critical need for each party. For the landlord, the need is to protect against the risk that continuing inflation will erode the value of fixed rent. For the tenant, the need is for a relatively low initial rent so that the retail operation has time to become profitable. The percentage rental is usually based on the gross receipts (or some alternative standard) related to the tenant's

business activity. The percentage lease thus is a compromise between a long-term fixed rent lease that may produce an unsatisfactory return to the landlord, and the short-term fixed rent lease that gives the tenant no assurance of long-term occupancy.

The sales volume that triggers the termination right for either party can be different for the landlord or tenant. The landlord may have the right to terminate the lease if sales fail to increase by a specified percentage at designated times during the lease term. For the tenant, the right to terminate might be based on the amount of sales the tenant must achieve to realize a profit. The tenant also may seek the right to terminate (or at least pay a reduced rental) if sales have materially diminished because of reduced draw to a retail center resulting from the loss of a department store or other major tenant or reduced occupancy in the center.

Change of Name

A landlord often will lease space to a tenant because it has a well-recognized name likely to attract business to the property. In such case, the landlord may insist that if the tenant is acquired by another company and a change of name is involved, that the lease can be terminated. The tenant may find this objectionable because it reduces the tenant's ability to transfer ownership to another party. The tenant may be willing to agree that in no event would the business name of the business be changed.

Cross-Default Clause

It is sometimes the case that a major tenant will lease space in several locations owned by the same landlord. The tenant might then

seek cross-default clauses in each lease permitting the tenant to terminate all leases in the event any one location is forced to close. The landlord could similarly seek such a right in the event the tenant defaults in any one location.

Usage

Regional shopping centers provide customers with a bevy of choices with some properties carrying multiple tenants vying for the same customer's discretionary income or a diverse variety of tenants. Community and neighborhood shopping centers offer convenience by providing a complementary mix of tenants to meet the daily necessities of shoppers. In either case, the mixture of tenants in a retail center is important to bring traffic, and therefore shopping dollars, to the property. A landlord may be desirous of limiting the use of the leased space to maintain a palatable combination of tenants for shoppers and existing tenants alike. Existing tenants may have co-tenancy clauses that restrict competition in the center. New tenants may want less restrictive usage terms so they can expand business products or services and so that if the need arises to assign or sublet the space, a larger number of potential replacements will be available.

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Refinancing: Property Under Pressure

By Anthony La Malfa

As many individual properties, particularly hotels and office buildings, experience declining cash receipts, owners may be unable to pay oper-

ating expenses as well as debt service costs. An owner in this position should consider whether to seek a restructuring of the mortgage, particularly if the interest rate is significantly higher than current levels. How should an owner proceed in this situation? The first point to remember is that a lender will agree to restructure a loan only if convinced this is the least distasteful alternative in dealing with a loan under pressure. The lender also must have confidence in the borrower's ability to manage the property efficiently.

Restructuring Debt

Borrowers can seek to restructure debt in several ways:

- Reducing the debt service constant
- Accruing interest
- Using a cash flow mortgage
- Providing additional financing
- Creating good/bad loan

Reducing the Debt Service Constant

If a property is in a negative cash flow position, one approach is to cut the monthly constant by one or two percentage points. For example, a loan of \$750,000 might be secured by property originally valued at \$1 million that is generating net operating income (NOI) of \$100,000 annually. If the loan carries a nine percent interest rate and a 10 percent constant, debt service would be \$75,000, leaving a \$25,000 cushion. If high vacancies and increased operating expenses cut NOI to \$60,000, the property would have a negative cash flow of \$15,000. Reducing the constant to eight percent would put the property at a break-even point. A lender might agree to this for a specified time,

after which the constant would return to its former (or higher) rate.

Accruing Interest

Another approach to the same end is to reduce the interest payment rate and accrue the difference between the reduced rate and the contract rate. For example, the payment rate would continue at 10 percent with eight percent payable currently. Payment of the remaining two percent would be deferred for a period of years or until loan maturity. (One issue to consider is whether the accrued interest will itself accrue interest.) An advantage of this approach is that it is more likely to be deemed a modification of the existing debt rather than an exchange of old debt for new debt. The latter can have tax disadvantages for the borrower.

Cash Flow Mortgage

Under a cash flow mortgage, the lender receives all cash generated by the property except that required to meet operating expenses. The lender may require that its consent be a condition to any capital improvements or cash distributions to owners. This type of mortgage, in effect, treats the lender and borrower as partners, so the lender is likely to closely monitor operations. One risk with the cash flow mortgage is that if the property is subject to other loans, the cash flow lender risks being held liable to them or becoming subordinate to their liens if the lender's actions are deemed prejudicial to them.

Additional Financing

If the lender is optimistic about recovery possibilities, it may agree to advance additional funds to finance current operating expenses and to make capital improvements.

The new money can be secured by a junior mortgage on the property or by other collateral, such as personal assets of the borrower. If the property already is subject to junior financing, the junior mortgagee may be willing to subordinate his loan to the new loan, since it is his interest to avoid a foreclosure.

Good/Bad Loans

If the current value of the property is substantially below book value, the existing loan can be separated into a good loan and a bad loan. The good loan, calculated as a percentage of current market value, might carry a market interest rate. The bad loan, calculated as a percentage of the difference between market value and book value, might pay a reduced or deferred rate, or it might be structured as a cash flow mortgage.

Participation by Lender

In return for any of the relief measures described above, the lender may require a participation in future cash flow or refinancing/sale proceeds. Alternatively, the original loan can be divided into a conventional mortgage and a participating mortgage. Initially, no return may be received by the lender on the participation loan since all cash flow available for debt service will go to the conventional first mortgage. However, if and when the property turns around and cash flow increases, the lender can anticipate receiving a participating share.

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Investments: Land Purchase Leasebacks

By David Tevlin

For passive investors, land purchase leasebacks are attractive in an economic environment such as now, when the outlook is for low inflation and limited (if any) growth. Buying land already improved or about to be improved offers no depreciation deductions or other tax shelter and carries a return somewhat lower than that on improved real estate. On the other hand, well-located land is a very desirable commodity because of its permanence, the priority of its claim to rent over other participants in cash flow, and its long-term appreciation prospects (provided the ground lease is carefully drawn).

Traditionally, investors in land purchase-leasebacks have been pension funds, educational institutions, or other investors with no need for tax benefits. However, private investors with a long-term outlook (particularly in connection with family trusts) have built substantial fortunes in the past through the ownership of land subject to long-term ground leases.

New Construction and Loan Refinancing

A common use of land purchase leasebacks is to aid in financing new construction. Developers who sell and lease back raw land (or lease directly from the original owner) can reduce their equity requirements, since construction costs can be fully financed with a construction loan. Furthermore, ground rent is fully deductible, whereas mortgage payments are deductible only to the extent they are for interest rather than loan amortization.

The other typical use of land leasebacks is the refinancing of income properties that require extensive renovation or that are being converted to a different use. By utilizing a land sale-leaseback, the property owner generates new capital at a lower cost than by mortgage refinancing because the long-term appreciation in land value is transferred to the land purchaser. At the same time, the seller-lessee retains depreciation write-offs and can fully deduct the land rent.

Repurchase Option

If the land seller-lessee retains an option to repurchase the land at some time in the future, the land buyer cannot regard himself as a permanent holder. Further, any price formula other than repurchase at then-current market value creates the risk that the IRS may construe the transaction as one between lender and borrower rather than between buyer and seller. In such an event, rent payments would be recharacterized as debt service on a mortgage, with undesirable tax consequences to the parties.

Return on Investment

When analyzing a land purchase leaseback, the investor's primary concern is to calculate the initial yield as well as the internal rate of return (IRR) over the projected holding period. A fixed ground rental often is two to three percent below the interest rate on a long-term fixed-rate mortgage (although this may not be the case when interest rates are low in a recession). The purchaser accepts the lower initial return because he expects to benefit from the land appreciation over the life of the lease. In addition, ground leases usually provide for rent increases tied to periodic

reappraisals of the land. If the fee interest is subordinated to a mortgage taken out by the lessee (see below), ground rent and IRR should be several percentage points higher to reflect the additional risk.

Nature of Security

The landowner's interest is not subordinate to the claims of any other party, and his right to ground rent takes priority over all other private interests. The picture is different if the landowner voluntarily subordinates his fee interest to a mortgage taken out by the ground lessee. This often is necessary if the ground lessee is to obtain construction financing to put up an improvement. In that event, the mortgage covers both land and building, so that a default by the lessee requires the land-owner to cure the default or risk a foreclosure against his fee interest.

Other Features of Leasebacks

Other features of land sale leasebacks of interest to prospective investors include the following:

- **Fee mortgage.** An investor holding a fee interest can obtain first mortgage financing on desirable terms, reflecting the high quality of the security. This can enable him to put up only a fraction of the total cost in cash. However, since the ground rental is not likely to be higher than the debt service on the mortgage, the investor will not achieve any upside leverage. An investor willing to devote most or all of the ground rental to servicing the mortgage will be able to carry a substantial interest in land for a very small cash investment—an attractive way for a family trust to create long-term value.
- **Liquidity.** Well-located land, even though subject to a long-term

lease, is often in demand, so that an investment often can be liquidated if the owner desires.

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Development: Vested Rights Doctrine

By Alvin Arnold

An Illinois appellate court ruled that under the vested rights doctrine, a developer could proceed with a project despite a down-zoning of the property by the municipality. *Cribbin v. City of Chicago*, 893 N.E.2d 1016 (Ill. Ct. App. 2008).

Anthony Cribbin and his partner bought land in Chicago on which they planned a condominium project. Circumstances beyond their control caused delays for several years. Despite this, Cribbin proceeded with the plans, incurring significant expenses in the process. Finally, in October 2003, they sought building permits from the city. However, the alderman of the ward in May 2004 was successful in having the parcels down-zoned, rendering Cribbin's construction plans unfit and arguably precluding any profitable development of the land.

Vested Rights Doctrine

Cribbin sued the City of Chicago, arguing that he had acquired vested rights by virtue of the substantial expenses incurred in reliance on the original classification. He sought a writ of mandamus that would compel the city to issue the building permits. The trial court ruled in his favor and the city appealed. The court's ruling was based on the doctrine of vested rights that allows a

developer to proceed with original plans if the developer can show that substantial expenses have been incurred in good faith reliance on the prior zoning classification.

The City of Chicago first argued that the trial court had inappropriately considered the subjective intent of the developers. Specifically, the city argued that the intent of the developers in the purchase and ownership of the land had no bearing on whether their right to proceed with construction had vested. The court disagreed, saying that while subjective intent does not by itself support a vested right claim, their intention is indicative of whether the developers were acting in good faith. A successful vested rights claim requires that the developer make substantial expenditures in good faith reliance on a zoning classification. Accordingly, subjective intent of the developer is “integral” to a determination that the developer’s interests are protected by the vested rights doctrine.

Substantial Expenses

The city then argued that the vested rights doctrine should not apply because the purchase price of the land should not be included in the developers’ expenditures, so that the expenses were not “substantial” as required by the vested rights doctrine. Again, the court ruled in favor of the developers. The court noted that several states have disagreed on this issue. Oregon courts have held that land cost should almost always be disregarded. On the other hand, it is settled law in Illinois that land acquisition costs can be considered if the “totality of the circumstances” so warrant. Here, Cribbin had bought the land with the sole intention of developing it and never changed that intention.

In addition, he continued to incur expenses for architects and other services despite numerous delays caused by others. Further, the developers sacrificed other valuable business opportunities rather than terminate this project. Consequently, inclusion of the purchase price was appropriate. Finally, the city questioned whether the expenses incurred by Cribbins were substantial in fact. The court ruled that they were substantial, given that the purchase price of the land itself was \$260,000.

Conclusions

Whether a developer will be protected by the vested rights doctrine is highly dependent on the facts and circumstances of each case. The vested rights doctrine will not always rescue a developer who simply failed to exercise vigilance over the zoning regime affecting the property. Costs incurred by a developer after a zoning change has been made may not be counted by a court applying the “substantiality” test. In addition, a developer may fail in a claim because he failed to protect himself in other ways. For example, a developer who conditions the acquisition of land on obtaining proper zoning permits is not likely to be successful in a claim under the vested rights doctrine.

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The United States: Demographic Trends

Population trends – who lives where – are the ultimate determinant of real estate values. A critical source of information about demographic trends are the periodic reports by The Brookings Metropolitan Policy

Program. The most recent report calls upon the government to develop policies and programs reflecting the latest population trends, especially those shaping metropolitan areas that are the engines of economic growth and opportunity. An overview of these trends is given below.

Slowing Migration

Migration across states and metro areas slowed considerably in the past two years due to the housing crisis and the recession. About 4.7 million people moved across state lines in 2007 to 2008, a drop from the historic high of 8.4 million people at the turn of the decade. Population growth has dropped in key Sunbelt cities such as Las Vegas, NV, Riverside, CA, and in Florida, which actually experienced a net loss from 2007 to 2008. Reflecting this, out-migration has slowed in older regions such as Chicago and New York, as well as many Midwestern and Northwestern cities, which in some cases saw population gains.

Immigration Shifts

At the same time, the sources and destinations of U.S. immigrants continues their long-run shifts. About 80 percent of the U.S. foreign-born population in 2007 came from Latin America and Asia, up from 20 percent in 1970. The Southeast has become the fastest growing destination for foreign-born, with such metro areas as Raleigh, NC, Nashville, TN, Atlanta, GA, and Orlando, FL, ranking among those with the highest recent growth rates. Increasingly, the new immigrants are moving away from communities in the urban core, with more than half of the nation’s foreign born residents now living in major metro

suburbs, while only one-third live in large cities.

Minorities Grow

Racial and ethnic minorities are driving the nation's population growth and resulting in increasing diversity among younger residents. Hispanics account for about half of the nation's population growth since 2000. Currently, racial and ethnic minorities represent 44 percent of U.S. residents under the age of 15. They are a majority of that age group in 31 of the nation's 100 largest metro areas (and a majority of the entire population in 15 metro areas). Hispanic populations are rising in a number of Sunbelt and high-tech centers and African-Americans continue their move toward large Southern metro areas like Atlanta, Houston, and Washington, DC.

Massive Senior Growth

The next decade promises massive growth of the senior population, especially in suburbs unaccustomed to housing the elderly. The first wave of baby boomers reaches 55 in less than two years and the senior population then will grow by 36 percent

from 2010 to 2020. The most increase will be in the Intermountain West, the Southeast and Texas. Because the boomers are the nation's first fully suburban generation, their aging in place will cause many major metro suburbs – such as those in New York and Los Angeles – to “gray” faster than their urban counterparts.

Rising Poverty

Even before the current recession began, poverty rose since 2000 and spread rapidly to suburban locations. Currently, working-age Americans account for a larger share of the poor than in the past 30 years. The suburban poor surpassed the central city poor in number during this decade and now outnumber them by more than 1.5 million. The suburban poor have spread well beyond the older inner-ring suburbs that in recent years housed less than 40 percent of all poor suburban dwellers. The report concludes by saying that the continued dynamism of our metro areas raises key policy and program issues for the government.