



## Real Estate

# MONITOR

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### Mortgage Securities: New Life?

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In a transaction that may be the beginning of a new life for real estate financing in the form of commercial mortgage backed securities (CMBS), Developers Diversified Realty Corporation (DDR) in November sold \$400 billion of debt backed by shopping centers under TALF, the Term Asset-Backed Securities Loan Facility, in an offering underwritten by Goldman Sachs Group Inc. DDR was able to sell \$323 billion of five-year securities rated AA A at a premium of only 1.4 percentage points over the five-year interest rate swap benchmark. The yield to investors was 3.807%. In addition, two smaller non-TALF issues rated AA drew strong interest; these had yields of 5.75 percent and 6.25 percent.

However, many investors did not take advantage of the TALF loans, preferring to pay cash for the securities. According to J.P. Morgan Chase and Co. other AAA mortgage-backed securities with the same maturity were priced at about 3.5 percentage points more than benchmarks. This still is a significant drop from the 13 percentage points over benchmark that was the case at the beginning of the year.

DDR owns 670 shopping centers in the United States and abroad and originally had hoped to raise a total of \$550million. According to a Reuters report, as much as \$70 billion in commercial mortgages are due to be refinanced in the next two years. By one estimate, defaults could be as much as \$250 billion in commercial real estate losses in the course of the refinancing.

#### Looking Ahead

The crucial question is whether this transaction is a reflection of a new market for securitization or whether it is an anomaly. The transaction was financed at about 55 percent of loan-to-value, which contributed heavily to its success. The question to be answered is whether the DDR success is the harbinger of future CMBS deals at loan-to-value-ratios necessary to finance loans coming due in 2010.

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## Financing: Lender Recourse in Non-Recourse Loans

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Commercial mortgage loans traditionally have been non-recourse, with the lender agreeing to look solely to the real property securing the debt in the event of the borrower's default. The lender knows the borrower cannot abscond with the security and relies on the underwriting process to assure the adequacy of future rental income to pay operating expenses and service the debt. At a time when lender and borrower achieved a continuing relationship, it traditionally was assumed that if the borrower did default, he would agree to a negotiated remedy (such as a deed in lieu of foreclosure); or, if a foreclosure proceeding was begun, the borrower would not seek to unreasonably delay the process.

The 1980s changed the picture. Both borrowers and lenders, seeking to avoid heavy losses, sought to protect their respective interests in every way possible. Many borrowers, facing foreclosure, resorted to a bankruptcy petition, litigation alleging bad faith by the lender, or other delaying tactics that frustrated lenders seeking to gain possession of property or otherwise exercise their rights under the mortgage. Lenders discovered that the non-recourse mortgage had a serious defect: it failed to provide solutions to the practical problems of enforcing remedies after default. The result was the development of "carve-out" provisions in nonrecourse mortgages designed to assure a lender that a defaulting borrower will be forced to decide quickly either to perform under the mortgage or to abandon the property to the lender. Some examples of carve-out provisions are discussed below.

### Initial Term Recourse

Personal liability by the borrower may be required during the initial years of the loan. This is particularly appropriate for newly constructed or distressed properties that are not expected to have a cash flow cushion (after operating

expenses, debts and debt service are paid) for several years. An alternative approach is to require recourse until specified rental or net operating income (NOI) levels have been reached, as specified in the underwriting criteria of the lender. Again, the purpose is to protect the lender until he is satisfied the property can carry itself.

### Top-of-the-Loan Recourse

Just as a cash flow cushion gives the lender assurance that debt service will be paid, an equity cushion gives the lender some assurance that in the event of a default, the property value will, at the least, equal the outstanding debt. A lender thus may require personal recourse for the top 10 or 20 percent of the initial loan amount, with liability declining as the loan is amortized. In drafting this type of provision, it should be clear that recourse will be reduced over time. Otherwise, the lender may take the position that the borrower is responsible for a specified dollar amount of the loan over its entire term.

### Property Taxes and Mechanics Liens

When a lender agrees to look solely to the property for satisfaction of the mortgage, he does not intend to eliminate the borrower's personal liability for property taxes and mechanics liens. Some courts, however, have construed non-recourse language to cover such obligations, with the result that a foreclosing lender will have no recourse against the borrower if forced to pay those obligations to the extent that they have priority over the mortgage lien). To avoid this result, the loan documents should make it clear that the non-recourse clause does not extend to these obligations.

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### Fraud or Misrepresentation

The borrower normally is required to make a number of representations in the loan documents—for example, the condition of the property, the absence of environmental contamination, and the terms of existing leases. The lender will require the borrower to assume personal liability in the event these representations turn out to be false.

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From the borrower's point of view, it is important to clearly define what constitutes a misrepresentation or fraud. The borrower will seek to limit liability to situations of deliberate failure to disclose a fact known when the loan was made. This will exclude liability for negligent misrepresentation, which covers failure to disclose information the borrower should have been aware of. The distinction is particularly important with respect to environmental contamination. If the borrower is personally liable for losses due to contamination about which the borrower should have known, the borrower may have an open-ended obligation. In effect, this amounts to an allocation of risk to the borrower that may not be the intention of the parties.

### Milking the Property

Finally, the lender will insist on personal liability for deliberate acts of the borrower in breach of the loan covenants or that reduce the value of the property. Examples include failure to pay property taxes on time, failure to maintain the property, and receipt of advance rents from tenants.

These acts sometimes are done when the borrower anticipates that the property soon will be lost to the lender. In addition, lenders may seek to "carve out" personal liability for borrowers if financial statements required by the mortgage are not filed promptly when due. Delayed reports often are an early warning sign of distress.



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### Deductions: Business Losses Not Passive

In a major victory for individuals in limited liability partnerships (LLPs) and limited liability companies (LLCs), the U.S. Tax Court has ruled that the members in such firms were not required to treat losses as passive, as in the case with limited partnership (LP) interests. *Garnett v. Commissioner*, 132 T.C. No. 19, 2009 WL 1883965 (U.S. Tax Court).

#### Background

The heart of the controversy before the court was Section 469(h)(2) of the tax code, which treats losses from certain limited partnership interests as passive (and so deductible only against passive income). The section in question specifically provides: "Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which taxpayer materially participates."

The petitioners here held an interest in one limited liability partnership (LLP) and held interests in six other LLPs indirectly through several limited liability companies (LLCs). The various companies all were engaged in agribusiness operations (production of poultry, eggs, and hogs) but the decision here applies broadly to all forms of businesses that operate in the form of a LLCs or LLPs. The key advantages of such companies and partnership are to provide (1) the same protection against personal liability as shareholders in a corporation and (2) the elimination of the double taxation that applies to a corporation and its shareholders. The IRS has taken the position that losses of LLCs and LLPs are passive losses and cannot offset income from salaries, capital gains or dividends, but can only offset profits from other passive income LLPs and LLCs.

#### Ruling

The Tax Court first noted that when Section 469(h)(2) was enacted in 1986, neither LLCs nor LLPs existed. The court began its analysis by considering the differences between limited partnerships (LPs) on the one hand, and LLPs and LLCs on the other. A limited partnership (LP) has two classes of partners, general and limited, the latter being "passive investors." An LLP is a general partnership that by making a filing obtains a form of limited liability for its partners. In the Garnett case, the LLP agreements generally provided that each partner would actively participate in the control, management and direction of the business. An LLC is essentially a hybrid of a corporate and a partnership form of business. Notwithstanding these differences, both types of partnerships are treated for federal income tax purposes as partnerships.

The IRS contended that ownership interests in LLCs and LLPs were presumptively passive under the limited partnership rule contained in the statute covering passive activities. However, the court ruled that the petitioners here, by their ownership interests in LLPs and LLCs, could participate in management under state law, unlike a limited partner interest. The court therefore ruled that the petitioners' ownership interests in the LLPs and LLCs are accepted from the classification as "limited partnership interests." As a result, the members of the LLPs and LLCs could deduct the farming losses against their other income if they materially participated in these activities.

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### Corporate Real Estate: Lease Auditing Revisited

More and more landlords are using excessive lease audit restrictions to win the “Battle of the Operating Expense Bulge.” By now, it is certainly no secret that a growing number of corporate tenants have reaped sizable benefits and significant financial recoveries by initiating lease audits. The practice of lease auditing has become commonplace within the real estate industry for many reasons, not the least of which is saving and recouping improper or excessive operating expenses, real estate taxes, utility and other related pass-through costs associated with leases. The lease audit practitioners have made this exercise even more attractive by performing their services on a contingency basis, so that there is little to no financial risk to the tenant in having these opportunities explored. Moreover, the continued evolution of lease administration processes, including those associated with required due diligence and testing procedures associated with the Sarbanes Oxley Act, have further won over tenants with respect to the merits of lease audits.

#### Landlords Reaction

Landlords, however, are increasingly fighting back in an attempt to prevent lease audits by insisting during lease negotiations, that restrictive and draconian provisions are included in the lease document that greatly limit tenants from undertaking a lease audit. Historically, lease documents routinely have included some level of restrictions with respect to how and when lease audits can be performed. Mainly, this objective was achieved by allowing the tenant only a certain time period, perhaps as short as 30, 60 or 90 days in which the tenant could notify, contest, or audit its annual operating expenses once having received the final statement of annual reconciliation of operating expenses and real estate costs. Although this restriction (also referred to as the “lease audit window”) can be useful in locking out tenants who were unaware of this restriction or were tardy in their

notification efforts, at least there was a reasonable mechanism in place so that a prudent tenant could review such costs and challenge those seen as improper on a timely basis. Also, larger and more sophisticated tenants might hold out during lease negotiations for a period of six months to a year with respect to having a lease audit performed.

For their part, landlords have routinely claimed that audits are time consuming and absorb valuable time from their staff and are unnecessary since their statements are reviewed by their own CPA firm. While noting that by most accounts 90 percent of lease audits do result in a financial benefit to the tenant, it should be acknowledged that landlords and their employees should be afforded some regard to their time and priorities.

#### Who Does the Audit?

Many landlords also require that the auditor be either a major or nationally recognized CPA firm. The rationale for this restriction is usually based on the claim that they wish to avoid a “wild” or disreputable lease auditor creating havoc by “throwing some things on the wall in order to see what sticks.” This claim is widely exaggerated, as most lease audit firms perform their duties in a professional manner and recognize that ultimately a successful recovery is only secured by full cooperation of landlord and tenant. It also should be understood that the landlord should not have the right to choose the consultant or limit the choice to certain firms.

#### Contingency Fees

Many landlords now seek to have the lease contain a clause requiring the lease auditor not to be compensated on a contingency basis. Many believe this is intended to reduce fees and by doing so discourage auditors to take on long term assignments. On the other hand, landlords may use this restriction as a way to discourage tenants from

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## Corporate Real Estate: Lease Auditing Revisited

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having audits performed by shifting the focus of risk directly from the auditor to the tenant. On many occasions, this scenario has worked as many companies that otherwise would have been more than happy to have an audit performed, assuming that they have no financial risk, are unwilling to expend any dollars unless there is some prospect of a guaranteed return and no reputable lease audit firm can guarantee a recovery.

### Concluding Thoughts

While negotiating a lease is always a challenge, given the adversarial relationship of the parties, tenants should seriously consider the impact of any restrictions with respect to lease auditing. Operating expenses are an important part of most leases and landlords are aware that a lease audit clause that includes such provisions as a short window (less than 90 days), limiting the audit to the "Big Four" accounting firms, or a non-contingency payment clause, means the tenant may encounter significant hurdles to in preventing unjustified charges. Regardless of the economic climate, business firms should periodically review all significant costs to verify they are being billed accurately.

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## CMBS: Maturity Extensions

A report from Standard & Poor's (S&P) last month shows that maturity extensions of mortgage securities can help prevent liquidations at distressed levels. Since such extensions are likely to play a significant role in distressed commercial mortgage-backed securities (CMBS) property sales, S&P asked several special servicers to estimate the frequency of extensions. The results showed that between 20 to 50 percent (depending on the servicer) of the loans transferred for imminent or actual maturity defaults between January and September were extended or were being considered for an extension.

As a general rule, special servicers were providing maturity extensions to borrowers unable to receive refinancing due to current market conditions. The extensions could give borrowers time to find a refinancing source. The extension all so could enable the special servicer avoid the difficult job of liquidating the loan in the stressed commercial real estate market. S&P also heard from many sources that such extensions often only delay the inevitable, particularly at a time when values are not climbing and when many expect that distressed asset sales from banks will push values even lower. S&P says its view is that extending well-performing loans with strong current and expected cash flows can help prevent additional expenses and avoid losses that result from attempts to force the liquidation of properties at distressed levels. At the same time, S&P believes that for loans with weak current and expected cash flows, servicers should enforce the provisions of the loan agreement and liquidate the property as quickly as possible in order to limit trust fees and expenses. S&P also understands that when servicers extend loans, they usually will seek concessions from borrowers in order to create a stronger loan. Concessions might include adjusting the interest rate, implementing a lock-box, posting reserves for leasing or tenant improvements, or requiring the borrower to reimburse the trust for special servicing fees.

S&P also reported that an increasing number of fixed-rate matured loans paid off in the third quarter of 2009. More than 60 percent of fixed rate loans paid off compared with 50.7 percent in the first six months. More loans being paid off contributed fewer loans being transferred to the special servicers, with 30.7 percent being transferred in the third quarter compared to 44.8 percent in the first two quarters of the year. Retail loans experienced the most significant change in payoffs, with 60 percent of matured loans paid off in the quarter, up from 29 percent in the previous two quarters.

The 1999 vintage was the most active with respect to retail maturities as 36 matured loans paid off. According to Real Capital Analytics, third quarter retail properties sales rose 36 percent from second quarter levels, representing the first quarterly rise in two years. While this is encouraging, S&P believes that liquidity is still very constrained for all commercial real estate sectors, including retail. S&P expects retail sales to remain low as the sector continues to struggle with rising vacancies and reduced consumer spending. The retail vacancy rate reportedly reached 10.3 percent, the third quarter, the highest since 1992.



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### Brokerage: Commission Earned

The South Carolina Court of Appeals ruled a real estate broker remained entitled to a commission even though the initial sale was stopped by a foreclosure but then was sold again to the original purchaser. *Springs v. AAG*, 2009 WL 2025639 (S.C.App.).

AAG entered into a contract with Springs, a brokerage firm, to sell land valued at \$1.2 million. The commission was to be 10 percent of the sale price. AAG found a buyer for \$1.17 million. Payment was to be \$345,000 at closing and the balance pursuant to a promissory note. The parties agreed that Springs would receive \$37,000 at closing and the balance of the commission by receiving 10 percent of 10 payments to be made under the note. The buyer defaulted on the first payment and AAG foreclosed on the property. At the public auction, the original buyer repurchased the property. The parties then separately negotiated an agreement covering the deficiency judgment. However, AAG did not pay Springs any additional commission. Springs sued. The case was referred to a master, who entered judgment against AAG for \$424,000, comprised of the remaining commission, attorneys' fees and pre-judgment interest. AAG appealed.

#### Appellate Court Ruling

The court of appeals stated the general rule to be that a broker's right to compensation is not defeated by the failure or refusal of the purchaser to consummate the contract. However, the general rule may be modified by agreement. In this case, Springs commission was due upon any one of the following events: (1) sale of the property; (2) a valid contract to sell the property but the seller fails or refuses to complete the sale; (3) the presentation to the seller of a valid written offer to purchase the property that complies with the terms and conditions specified in the contract.

Here, once the contract was signed, Springs was entitled to a commission regardless of whether

the buyer completed the purchase. AAG's argument was that the agreement between it and Springs was that Springs agreed to have the commission paid pro rata as the promissory note payments were made and this created a condition precedent so the commission payments were contingent on the buyer making the payments under the promissory note. Springs, on the other hand, argued the letter did not create a condition precedent because no language in the letter shows a meeting of the minds that Springs would not be entitled to a commission until payments were made.

Said the court, "Although Springs did sign the letter, when it did so, it had already done what the contract required it to do to receive its commission because AAG and the buyer had signed a sales contract." Further said the court, "If AAG had wanted to ensure it only owed Springs a commission if and when the buyer made its payments, AAG could have used language stating no commission was due unless payment was made...." The court affirmed the master's ruling.

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