



Real Estate

MONITOR

Special Servicing: A Developing Nation

A special servicer is an entity that deals with troubled or delinquent loans within a pool of commercial mortgage loans. Generally, the special servicer, who is often also an owner, or related to the owner, of the lower-rated tranches of commercial mortgage-backed securities (CMBS), is named within the Pooling and Servicing Agreement (PSA) between the investment pool trustee and the master servicer. The PSA outlines the conditions under which the servicing of a loan or pool of loans will be transferred to the special servicer.

The special servicer generally has a broad range of powers conferred on it by the PSA, including extending the loan, restructuring the loan, and foreclosing on the loan. The special servicer is required to adhere to the servicing guidelines within the PSA, and may also have to comply with Real Estate Mortgage Investment Conduit (REMIC) rules to protect the tax-free status of the trust in which the loan is pooled.

The role of the special servicer is of increasing importance as the risk of loss increases the lower one goes in the tranches of an investment pool since the attentiveness and actions of the special servicer will have a direct impact on any losses incurred.

Special Servicers and the Financial Crisis

During the financial crisis, faced with an unprecedented volume of distressed loans, many special servicers came under pressure for not always acting in all of the bondholders' interests and not having adequate resources to deal with the myriad of issues they were facing.

On April 5, 2010, Arleen Jacobius wrote the following in *Pensions and Investments Online*. "The current financial crisis is the first test of the CMBS market, which exploded between 2004 and 2007. A total of \$1.4 trillion new CMBS's were created in 2007, three times the total issued between 2000 and 2003. Most will not be

refinanced, and it is the job of the special servicer to work out the loans or foreclose on the properties. However, some servicers have cash problems. The value of their CMBS investments is falling and the debt financing the investments is coming due." As the commercial real estate market continued to deteriorate during 2009 and 2010, a number of special servicers became acquisition targets for larger (and more stable) real estate investors. During this time, three of the ten largest special servicers were acquired. The acquisitions were seen more as a way for investors to identify distressed assets rather than as the diversification of their ongoing businesses.

The Changing Landscape

Several changes to the special servicing model are being debated, from ways to ensure the special servicer is independent of the bondholders to the ways they are compensated, all in an effort to improve the securitization model for future investors.

The CRE Finance Council, the industry trade group that controls the reporting standards for CMBS reporting, has developed updated market standards for future CMBS transactions, dubbed "CMBS 2.0." These market standards are intended to result in improvements in three critical areas: loan underwriting, additional disclosure, and representations and warranties. One change related to special servicer is that the decision to select the servicer is up to most, if not all, of the investors in the loan by majority vote.

In August 2010, Goldman Sachs offered to give control over the servicing of a new CMBS issuance to the triple-A rated tranche investors rather than the subordinated classes as was usually the case. This change in the control over servicing was a key departure from standard practices as the subordinated-tranche holders (who previously had control over the special servicer) would normally be inclined to extend or modify troubled loans whereas



Special Servicing: A Developing Nation

triple-A rated tranche holders would generally foreclose on the loan and liquidate the property. This shift in control, although it does not achieve the ideal of independence, addresses a significant complaint of the senior bondholders in past transactions and was prevalent in a number of subsequent 2010 CMBS deals.

Although one cannot predict the exact form the role of the special servicer will take in future CMBS issuances, we can be certain the role of the special servicer will continue to be an important step in the loss mitigation process, especially as long as commercial mortgage loan delinquencies remain high and credit continues to be elusive.

Arleen Jacobius' article "*Special Servicers' Cure Could Prolong Commercial Real Estate Market's Ills*" can be accessed at:
[http://www.pionline.com/article/20100405/PRINTS
UB/304059991](http://www.pionline.com/article/20100405/PRINTSUB/304059991)

Information regarding CMBS 2.0 issued by the CRE Finance Council can be accessed at:
<http://www.crefc.org/committees.aspx?id=19381>

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Real Estate

MONITOR

Abandonment of Partnership Interest

A taxpayer who abandons, or forfeits, a limited partner's ownership interest without consideration could be entitled to an ordinary loss deduction rather than a capital loss. This would be beneficial to a taxpayer who does not have capital gains to offset a capital loss from a real estate investment that has failed.

If a partner abandons a partnership interest, or forfeits a partnership interest in accordance with the entity's agreement for no consideration, a loss is realized in the amount of the partner's adjusted tax basis. The character of the loss for tax purposes has been the subject of an Internal Revenue Service ruling and some court cases.

Generally, if a partner receives an actual or constructive distribution, or has a reduction in liabilities due to an event, any resulting loss is deemed from the sale or exchange of an interest. Under the tax code, the sale or exchange of a partnership interest would be a capital loss. However, an IRS ruling deemed a loss to be ordinary in a case where a limited partner abandoned a partnership interest, and the partner did not bear an economic risk loss for partnership liabilities nor include a share of partnership liabilities in adjusted tax basis. The IRS noted that the partner received nothing in exchange for the partnership interest, and the situation was similar to the partnership interest becoming worthless.

This ruling is consistent with the decision in court cases involving similar situations. One case involved the abandonment of a limited partner interest where there were no liabilities referenced to any of the limited partners. Since the abandonment did not cause a decrease in the limited partner's share of liabilities, a deemed distribution to the partner did not occur under the tax code. Thus, the taxpayer was entitled to ordinary loss treatment with respect to the abandonment of the partnership interest [Citron v. Commissioner, 97 T C 200].

In another case, a partnership owned a tract of unimproved land. Originally the partners expected a new highway would be built adjacent to the land which would attract development and a resale of the land for a profit. Worsening economic conditions and a delay in construction of the new highway resulted in the partnership being unable to sell the land. The partner indicated he would no longer contribute funds to the partnership and was going to walk away from the ownership interest in the partnership. The Circuit of Appeals Court ruled that the partner had abandoned the interest in the partnership and was entitled to an ordinary loss based upon worthlessness. [Echols v. Commissioner, 68AFTR 2d 91-5157(953 F.2d 703)].

To treat the loss as ordinary due to abandonment, rulings and cases discussed above all indicate that the partner must demonstrate an intent to abandon by some overt act or statement to give a third party notice. Whether an overt act has occurred must be determined based upon all facts and surrounding circumstances. Certainly written notification to the partnership should be part of the necessary steps to effectuate a proper abandonment.

In summary, it is possible to characterize a loss from an abandoned partnership interest as ordinary, as opposed to a capital loss, in certain situations. The taxpayers and their advisors should review whether the partnership has liabilities allocable to the limited partner, whether the interest is worthless, and what steps are necessary to abandon the partnership interest if appropriate.

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Real Estate

MONITOR

EB-5 Regional Centers

When capital from traditional financial institutions and investors is tight, non-traditional avenues garner increased attention. One such avenue has been expanding rapidly in the wake of the capital shortages that have followed the subprime crisis: EB-5 investments. These are investments made by foreign nationals in new commercial enterprises in order to secure legal permanent residence status in the U.S.

While the EB-5 program has nominally existed since 1990, it was originally hamstrung by strict requirements, bureaucratic delays and inconsistent rulings and regulations. However, a series of improvements in recent years have loosened the technical requirements and provided greater certainty to EB-5 investors that they will actually have permanent resident status, encouraging the growth of the program.

The program originally required investors to put at least \$500,000 at risk in an investment that benefitted the U.S. economy and directly created at least 10 jobs. The minimum investment now is \$1 million unless the investment is made in a Targeted Employment Area, with unemployment at least 150% of the national average. However, the program now allows investments to be made through Regional Centers that pool investments, so that the individual investor need not be responsible for directly overseeing the specific investments. Moreover, investments made through Regional Centers need not create 10 jobs directly; indirect job creation can be counted as well.

As of 2010, there were roughly 100 Regional Centers, each of which focuses on investments in an exclusive geographic territory. A Regional Center is any economic unit, public or private, that is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation or increased domestic capital investment. Regional Centers are designated by the U.S. Citizenship and Immigration

Services department through an application process in which the proposed center documents its business plans, showing how it will have an economic impact on the designated region and how it will prove that it has created at least 10 jobs per investor.

Regional Centers can participate in a large range of projects, and Center real estate investments include the development of commercial and professional office buildings, hotel development, shopping centers and retail space.

For a developer, the EB-5 program provides at least two avenues: soliciting investments through existing Regional Centers that have attracted investors, or setting up a new Regional Center to fund its own projects. Either way, it is important to recognize that the EB-5 program has numerous technical requirements, and that despite recent improvements, the program is subject to legal and regulatory uncertainties in addition to typical market factors. Moreover, most Regional Centers are new entities with plans and aspirations, but no track record on which they can be judged, so caution and due diligence are important in dealing with the EB-5 program.

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Real Estate

MONITOR

The Affordable Housing Crisis

The relative end of the mortgage crisis has left in its wake plummeted home prices, increased unemployment, and has resulted in many Americans losing their homes. This recession has triggered many to consider the benefits of renting, and in many cases, left others with no choice but to rent. The benefits of renting are extensive, and include transferring the responsibility of upkeep and maintenance to the landlord, not tying up funds in the form of a downpayment, and most importantly, eliminating the risk of loss of your investment. It is for this reason that most Americans rent at some stage in their lives. Moreover, even during the recent home buying boom, the share of U.S. households living in rental housing never fell below 30 percent. However, even though the first quarter of 2011 has shown signs of economic expansion, such as adding 192,000 jobs to the labor force (as per the Bureau of Labor Statistics), the overall unemployment rate is still high.

Additionally, a study performed by the Joint Center for Housing Studies of Harvard University compared current renters' cost burdens (which are defined as the cost of rent and utilities and should be less than 30 percent of household income) to those from the year 2000. They found that households where renters' costs were between 30-50 percent of income (defined as moderately cost burdened) increased 29 percent to 49 percent of renters, and households where renters' costs exceeded 50 percent of income (defined as severely cost burdened) increased 6 percent to 26 percent of renters. It is for these reasons, as well as many others, that have caused affordable housing to be in high demand.

Affordable Housing on the Rise

Federal housing assistance programs are generally required to target extremely low income households (defined as less than 30 percent of area medians) and very low income households (defined as 30-50 percent of area medians). The *American Housing Report* published by the Joint Center for Housing

Studies of Harvard University states that "at present, there are approximately 7 million federally assisted housing units nationwide, enough to house just one quarter of the lowest-income renters eligible for assistance." While there is a significant shortage of affordable housing units, there are indicators which seem to imply that the development and availability of affordable housing is on the rise.

- On March 31, 2011, New York State Governor Cuomo announced his state budgets. Included in his budget was the extension of the low-income housing tax credit by \$4 million in aggregate credit awards to taxpayers that develop qualifying housing projects for low-income New Yorkers. According to the 2009 American Housing Survey, six million (15 percent) of the nation's 39 million occupied rentals were assisted through the low-income housing tax credit program. This budget increase should therefore have a significant positive increase on the development of new affordable housing units. For example, Phipps Houses, one of New York's largest developer and manager of affordable housing with nearly 13,000 units, has over 1,000 units in the pipeline.

- In 2010, many of the affordable housing lenders saw an increase in activity primarily due to the federal stimulus money and record low-interest rates. The Affordable Housing Finance Agency says the biggest winner was Citi Community Capital, which provided close to \$3 billion to affordable housing projects, an increase of \$2.4 billion as compared to 2009. Many believe this momentum will continue in 2011.

- The Federal Housing Administration is working on making its construction to permanent financing program (section 221(d)(4) program) more user-friendly for tax credit deals, with the intention of stream lining the process and encouraging new investors to enter the industry. The past decade was not good for affordable housing. Falling renter



The Affordable Housing Crisis

incomes and rising rents were the primary causes in the first half of the decade, and were compounded by the recession and mortgage crisis in the second half of the decade. All in all, the number of severely cost-burdened renters climbed by 1.5 million in the first half of the decade to 9.1 million and by the end of the decade, that number increased to 10.1 million (as disclosed in the American Housing Report published by the Joint Center for Housing Studies of Harvard University). It is clear that the need for additional affordable housing units is dire. With the hope of more budget increases, additional government subsidy programs, and the possibility of additional tax breaks, the gap of the affordable housing demand will hopefully begin to decline to more manageable levels.

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Real Estate

MONITOR

Housing: Using Rolling Options

Housing markets have been very weak in recent months and new home construction remains at low levels. However, some hope is being expressed about the housing market beginning to improve, particularly if the economy shows signs of strengthening. Looking to the future, some developers may be thinking of tying up desirable land for residential subdivisions in attractive locations in order to assure themselves that land will be available when needed. One way to do so is by utilizing rolling options, viewed as a more conservative method of controlling land inventory than outright purchase. The option holder retains maximum flexibility so that if the economy remains weak, outstanding options can be left unexercised or can be renegotiated. (On the other hand, the option seller will tend to price land higher than in the case of a straight purchase as compensation for the uncertainty of a final sale, particularly if the option term is long.) And as with any option, failure to exercise means the loss of the option fee paid by the holder.

Rolling Options

Consider the position of a developer who has completed the legal steps of subdividing land into lots and recording a plat. At that point, preparatory to installing roads and utility services, the developer wants an agreement with a builder for construction of homes. The builder sees the possibility of new homes on the entire tract, but lacks the financing to purchase the land outright. Instead, the parties enter into a rolling option whereby the developer gives the builder a series of options to buy lots over a specified time period. The initial option may cover only a small number of lots on which the builder can construct model homes. If the market response is positive, the builder will then exercise the second option for additional lots for speculative homes or homes already contracted for. Each time an option is exercised, it rolls over to the next designated tract of land or series of lots, often at a stepped up price to reflect the additional land value created by

the subdivision. Failure to exercise an option, on the other hand, will eliminate any further rollover.

Benefits to the Parties

The benefit to the builder is his ability to control the entire tract at a minimum cost. It is true that if the entire tract ultimately is purchased through the exercise of the options, the total price would be higher than in the case of an outright purchase. However, the reduced exposure to risk justifies the extra cost. For the developer or landowner, the disadvantage of a rolling option is that lots or land cannot be sold to third parties until an option period expires without a rollover. However, he is receiving increasingly higher prices as options are exercised and would not be likely to find another buyer in the event the original builder fails to exercise some option.

Drafting the Option Agreement

The key provisions in a rolling option agreement relate to the price of each option, its time period and the portion of the tract covered by the option. As already noted, the price of each successive option typically increases, which, in effect, permits the landowner to share in the rising land value.

Due to the existing construction, a price increase may be a specified percentage, may relate to the sale prices of the finished homes, or may be affected by the characteristics of the portion of the land covered by the option. The time period within which each option can be exercised also is a matter of negotiation. The builder will want a longer time in the event sales proceed slowly; the landowner will prefer a shorter time so that sales proceeds are received more quickly. The builder may be agreeable to paying a higher option fee in order to extend the time of exercise. Alternatively, the builder may be given a right to extend a particular option upon payment of a specified fee. Finally, the option agreement must specify which portions of land are covered by each option. The owner will want each successive option to cover land

Housing: Using Rolling Options

immediately adjacent to that already developed, to avoid ending up with isolated portions that cannot easily be sold if all options are not exercised. On the other hand, the builder will want the right to reject any land or particular lots that cannot be built upon because of grade or subsoil conditions or similar reasons.

Developer as Optioner

When the rolling option agreement is between a builder and a developer who undertakes to render the lots suitable for construction of single family homes, a number of additional issues must be addressed. For example, the developer must agree to complete all work on a specific schedule to render purchased lots, suitable for the construction of homes and for the issuance of a building permit. The developer normally also will be required to perform any offsite work and to obtain easements for utilities and drainage. Any required permits and payment or performance bonds also should be specified in the agreement. To the extent that the local government requires the dedication of space for schools, streets or parks, the developer should be responsible for doing so. Finally, the developer should make the representation and warranties normally found in a sales contract, including those relating to zoning, good title, the amount of land conveyed and environmental issues.

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Real Estate

MONITOR

Brokers: Duty to Disclose Debt

A California appellate court held that a residential broker owed a duty to disclose to possible buyers the substantial risk that the seller could not transfer title free and clear of liens. [Holmes v. Summer, 188 Cal. App. 4th 1510, 116 Cal. Rptr. 3d 419 (4th Dist. 2010)].

The case involved a short sale, i.e., one in which the value of the home was less than the outstanding mortgage. Sieglund Summer, a broker, listed a home for sale on a multiple listing service for a price of \$749,000 to \$799,000. The listing noted the seller was a motivated one and that Summer would receive a 3% commission. Summer showed the property to Holmes, making no mention of any encumbrances on the property that might affect the ability of the seller to sell at the advertised price.

After some negotiation, Holmes agreed to pay \$749,000. Summer did not disclose that the property was subject to three trust deeds totaling \$1.41 million. After learning of this, Holmes then began their action for negligence, negligent misrepresentation, and deceit. Holmes also alleged that Summer was seeking to arrange a "short sale" which would have required the lenders to accept less money than was owed to them in order to retire the debt against the property. In addition, Holmes asserted that during escrow, the lenders refused to discount the loans and demanded full payment before they would release their liens against the property. The trial ruled in favor of Summer and dismissed the action. Holmes appealed.

The issue before the Appellate Court was whether the complaint alleges facts sufficient to state a cause of action, assuming the truth of the pleaded facts. The fundamental issue here, said the court, was whether the broker owed a duty of disclosure to the buyers. The broker represented that the property could be bought for \$749,000 and even negotiated a sale at that price, while knowing the

property was encumbered with over \$1 million in debt. Thus, the property could not be sold at the stated price unless either two or more lenders agreed to discount the debt on the property or the seller put \$392,000 in cash into an escrow account in order to pay off the loans. Furthermore, the seller had to gain the cooperation of two or more lenders. Holmes argued that considering the discrepancy between price and debt, the brokers were obligated to disclose the facts.

Summers, on the other hand, argued she was precluded from disclosing the financial issues affecting the transaction, since this would have required them to disclose the seller's confidential financial information or its strategy in determining the price at which they would be willing to sell.

The court stated the general rule in California as follows: "It is now settled that where the seller knows of facts materially affecting the value or desirability of the property that is known or accessible only to him and also knows that such facts are not known or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer." Here, according to the buyers, the monetary liens affected both the value and the desirability of the property. Because the broker knew of the debt and should have known that the buyers were not aware of the same, she had a duty to disclose the problem.

Here, the complaint asserted four theories of liability: (1) deceit based on misrepresentation; (2) deceit based on failure to disclose; (3) negligent misrepresentation; and (4) negligence. Said the court, a properly pleaded cause of action on any one of those theories would suffice to save off a demurrer. The court reversed the judgment of the trial court.

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Brokers: Duty to Disclose Debt

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