



Real Estate

MONITOR

Sales: Guarantee and Earn-out Provisions

Lender unwillingness to provide financing for buyers is a key cause of the current real estate market freeze. Even a buyer is in a position to pay cash maybe unwilling to buy property in view of the uncertain economic conditions. One solution is for a seller to take back a purchase money mortgage. But even in this case, a buyer may insist that the seller assume part of the risk that the property will fail if the economy continues to worsen. A way to do this is for the seller to guarantee a portion of the buyer's return or to enter into an earnout provision that closes the gap when bids and offers are too far apart.

Guaranteed Return

Assume the purchaser of a rental property insists the seller guarantee a specific occupancy ratio will be maintained or that net operating income (NOI) or gross rental income will be a specified amount. If the seller's guarantee is not met, the seller must either (1) reduce the purchase money mortgage by an amount equal to the difference between the guaranteed return and the amount actually received by the buyer or (2) refund a portion of the interest paid.

Example: Assume a buyer offers to purchase an income property for \$500,000 provided the seller will take back a purchase money mortgage for \$250,000. The property currently has a free and clear return of \$40,000, eight percent of the purchase price. Given the uncertainties in the present marketplace, the buyer insists on one condition. If the property yields less than \$40,000 annually for a specified period, the annual interest payment is to be reduced by the difference between the actual yield and \$40,000. The seller may agree to the guaranty provided it is for a relatively short time, say, two or three years. The guaranty is limited in amount because the seller cannot be liable for more than the annual interest rate on the loan.

An alternative approach is to for the seller to guarantee the gross rental income (or NOI) will not be less than a fixed dollar amount for a specified period of time after the sale. In this situation, the seller's guaranty extends to the entire return expected by the buyer. The seller can limit his potential loss somewhat by providing that the guaranty steps down by a specified amount for each year that the guaranty is in effect.

Fixed Price Subject to Earn-out Provision

In an uncertain real estate market when bids and offers can be far apart, one approach to close the gap is to utilize an earn-out clause. Such a clause provides that the sales price fixed in the contract will be increased in the event of certain changes in the operating experience of the property. Earn-out provisions have particular relevance in two situations. The first situation involves new construction where the takeout securing the construction loan takes the form of a purchase commitment rather than a permanent loan commitment. The purchaser, perhaps a pension fund, may be agreeable to a fixed price sufficient to take out (pay) the construction loan but does not wish to commit to a higher price until the property has been leased up to a specified percentage or otherwise satisfies minimum return requirements. This situation is comparable to the floor-to-ceiling permanent loan commitment made by a lender.

The second situation is a sale of a property to a real estate syndicator who must be able to assure prospective investors that a minimum cash flow will be achieved. Assume the syndicator is willing to commit to a price that will assure an eight percent distribution based on current cash flow. If this requires a price substantially below the seller's asking price, the syndicator may agree to add to the price by a designated amount at a later date if the building's return increases. (In this sense, an earn-out provision is comparable to a percentage rental

Guarantee and Earn-out Provisions

clause in a retail lease.)

Drafting an Earn-out Clause

An earn-out clause requires careful planning and drafting. The first matter to consider is the time period of earn-out. The time should be limited so that the seller does not become, in effect, the partner of the buyer. A measuring rod could be the estimated time period sufficient to permit the realization of projections made at the time of the sale. For example, if the neighborhood is experiencing an oversupply of space, a rough estimate could be made of the number of years necessary to absorb the excess space.

Another important consideration is the standard by which the property's operation will be measured. The least complicated standard would be an increase in gross rental income because this avoids the need to define the operating expenses that are deductible in determining net operating income. For example, if a property presently has gross rental income of \$100,000, the buyer may value the property by using a gross rental multiplier (GRM) of eight, giving the property a present value of \$800,000. An earn-out provision might provide that if within three years gross rentals increase to \$125,000, the value of the property would be deemed to be \$1million. The buyer might be willing to pay the seller a percentage of the increased value (say, 20 percent of the additional value of \$200,000, or \$40,000).

Complications can arise even when gross rental revenues are used. For example, the buyer may structure leases entered into during the earn-out period on a step-up rental basis, with low rents paid for the first year and subsequent rents to be stepped up. Alternatively, the buyer may find it necessary to offer several months of free rent in order to obtain tenants. The buyer then may insist that rents be leveled over the earn-out period when

calculating the earn-out payment. Because of such complications, the parties should retain legal and accounting counsel in drafting the earn-out provision.

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Real Estate

MONITOR

Real Estate Transactions: Two Failures

Time was when real estate transactions were usually between an individual buyer and an individual seller and involved a specific property. But as real estate became more of a commodity, tax rules changed to permit new methods of buying and selling property. Two such methods are the tax-deferred exchange (TDE) and the tenancy-in-common (TIC). Both have become very popular and have been instrumental in broadening real estate markets. But two recent occurrences illustrate new forms of risks that have arisen as well.

Tax-Deferred Exchanges

The financial crisis claimed new victims when a major title insurance company, acting as a qualified intermediary (QI), incurred substantial losses due to investment in auction rate securities in order to increase its profits on funds held for third parties. The firm, LandAmerica Financial Group, was holding an estimated \$400 million deposited by real estate investors who had sold properties and were seeking to enter into tax-deferred exchanges within the 180-day period permitted by the tax law. In such a deferred exchange, the seller of property must meet two time limits in order to defer tax on gain. The property to be received in exchange must be identified by the selling party no later than 45 days after the transfer to the QI and the party then must receive the replacement property no later than the earlier of (a) 180 days after the transfer or (b) the due date of the party's tax return for the year in which the initial transfer occurred.

Qualified Intermediaries

The QI, also known as an Accommodator, can be a corporation or an individual performing the following services: (a) arranging the documentation for the seller's property being sold; (b) holding the funds until the seller finds a replacement property; and (c) arranging the documentation to purchase the replacement

property that will be transferred to the seller. Unless otherwise set forth in an agreement, a QI can do virtually anything with the funds deposited with it. The only rules are that the QI cannot have acted as an agent of the party seeking the exchange within the past two years and cannot be related to the exchange party or to any agent of the exchange party. This includes attorneys, CPAs, and real estate agents.

The QI charges a fee for holding the funds during the exchange period. As noted above, the QI can invest the funds elsewhere for an additional return (a portion of which may or may not be given back to the exchange party). In the case of LandAmerica, most of the money was invested in auction rate securities backed by federally-insured student loans. While the loans themselves are fully insured, there is a risk that repayment to the investor may be delayed for some days or weeks.

Auction Rate Securities

Auction rate securities (ARS) are debt instruments that can have maturities as long as 50 years. However, auctions usually are held by financial institutions every seven to thirty-five days when interest rate can be reset and bonds can be bought and sold. In a normal market, this means the holder of ARS almost always can find a buyer, which in effect converts them short-term securities. Even if a seller cannot find a buyer, the broker-dealers who run the auctions usually will purchase the securities for their own accounts in order to assure the short-term nature of the debt. However, in February of last year, the leading financial institutions ended their role in supporting the ARS market, causing the market to collapse. Investors were left holding as much as \$330 billion in what now became illiquid securities. As a result, LandAmerica could not make cash available within the time period for real estate sellers to acquire exchange properties. Only those sellers that had insisted money be segregated and kept in bank accounts were able to obtain

Real Estate Transactions: Two Failures

the needed cash. LandAmerica did lend its 1031 subsidiary \$65million in cash to meet redemptions and also sold many of the auction Rate securities for about 80 cents on the dollar. However, many exchange parties were unable to invest their cash in new properties and so lost the benefits of a tax-deferred exchange.

Tenancies-in-Common

Sellers of real estate seeking to defer tax on gain can utilize another technique in order to comply with the requirement that an exchange must be completed within 180 days following a sale. This is tenancy-in-common (TIC) ownership, in which a seller can combine with other investors in jointly owning an income property. This usually can be done well within the 180-day time limit because real estate firms in many cities maintain an inventory of income properties in which an investor can acquire a share. However, Investors considering a TIC investment also should be careful to determine exactly how the real estate firm managing the TIC will operate. An example of some of the problems that can arise is the recent bankruptcy of DBSI, a real estate firm catering to small investors that recently filed for bankruptcy protection. The firm manages nearly 240 commercial properties valued at \$2.4 billion in 30 states with more than 8,000 investors.

DBSI, based in Boise, Idaho, offered its investors a unique feature – a guaranteed return beginning at 6.5 percent that would grow over time to 12 percent annually. The firm was able to do this because of its large number of TIC holdings. Weak returns in one property could be improved by borrowing from other properties that were more successful. In addition, the firm was prepared to use the fees it earned to support investment returns until conditions improved. However, the recent collapse of real estate markets brought an end to the process.

Investors, having ignored possible risks because of the 29 years of experience of the firm, now are on their own in dealing with management and financial problems that might arise at the property in which they have a share. Given that each property may have up to 35 investors who must make unanimous decisions, this is likely to be an extremely complicated process.

Multi-Family Properties

While most tenancies in common involve commercial property, the TIC also can be used for a residential property. Most residential TICs are in San Francisco. Banks often impose tighter mortgage-underwriting standards for residential properties than for businesses. As a result, the carrying costs for a residential TIC can be higher than for a business TIC. Until a few years ago, a residential TIC usually required all of the owners (whether living in the property or not) to join in a single mortgage. As a result, if one tenant defaulted, the remaining owners had to make up the loss. More recently, some banks offer so-called fractional mortgages that constitute separate loans to each buyer. An unusual feature of fractional mortgages is that they have very short terms, usually three to five years. As a result, if interest rates rise, costs also rise for the TIC owners. The initial impetus for residential TICs in San Francisco was as a way to bypass rent control laws that made it extremely difficult to convert properties to traditional condominiums.

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Real Estate

MONITOR

Financing: Recourse Loans

Although non-recourse lending is prevalent in real estate, there are times such as now when lenders will only loan on a recourse basis. In a recourse situation, the lender is unwilling to rely on the real estate as the sole security for the loan and requires additional assurances of repayment, either by the borrower himself or by third-party guarantors. A guarantee is an undertaking by a person to be personally liable for another's debt. It is a legal maxim that a guarantor is a favored person in the eyes of the law; that is, the terms of the guarantee will be construed by courts strictly in favor of the guarantor. Thus the lender must see to it that the guarantee is clear as to its coverage and the conditions that must be met before the guarantee is honored.

Types of Guarantees

When a borrower assumes personal liability for his or her own loan, the liability normally is general and unlimited. That is, if any kind of default occurs, all of the borrower's personal assets can be reached by the lender for payment of the loan. A third-party guarantor, however, usually will limit a guarantee in some way. This is particularly likely to be the case for an "outside guarantor," i.e., one who is not actively involved in the investment or business of the borrower. The most common types of limitations are described below.

Guarantees Limited in Amount

Frequently a third-party will limit a guarantee to a dollar amount that is less than the loan made to the borrower. A number of questions then arise that should be clarified in the guarantee agreement. The first is "which dollars." A mortgage normally is amortized over its life. Does a guarantee for "X dollars" refer to the first or last payment? In other words, is the guarantor released once debt payments are made by the borrower equal to the guaranteed amount?

A second question relates to an increase in the loan. Suppose the mortgage loan is refinanced at a future date and additional funds are advanced to the borrower. Does this invalidate the guarantee because the risk of default has been increased?

Guarantees with Date Limitations

A guarantee may specify that the guarantor is liable only for debts incurred by the borrower prior to a certain date. Alternatively, the guarantee may apply only to defaults after a specified date. For example, the guarantee may cover a loan during the lease-up period but expire when occupancy reaches a certain level. Occasionally, a guarantee may deal with a particular type of loss only. For example, if the lender is concerned with possible defaults due to environmental problems or the presence of asbestos in buildings, a guarantee may be required in connection with those specific causes. The guarantor should be careful to define the precise risks covered by the guarantee.

Anti-Fraud or Fidelity Guarantees

A lender may want assurance that all representations made by the borrower about the property are true. Thus, the lender may want a guarantee covering the representations in the loan documents—an "integrity" guarantee rather than a "credit" guarantee. Here again, questions of causality arise. In addition, it must be clear that the lender relied on the representations in making the loan, i.e., that they were "material."

Last-Out Guarantees

A guarantee always should make clear whether the lender must first look to the real estate securing the loan (or the personal liability of the borrower) before proceeding against the guarantor. The law distinguishes between a collection guarantee and a payment guarantee. A collection guarantee means that the lender must first reduce his claim to judgment and seek to satisfy the judgment against



Financing: Recourse Loans

the real estate or the borrower personally (if it is a recourse loan). A payment guarantee means that the lender may proceed against the guarantor without resorting to the collateral or to the borrower.

Conditional Guarantees

A final type of guarantee is one subject to a condition. For example, the guarantee may become effective only if the lender obtains similar guarantees from other specified persons or only if the borrower fails to raise a certain amount of equity capital. In a real estate situation, a guarantee may come into effect only if the property fails to generate a specified net operating income or if the appraised value of the property falls below a specified figure.

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Real Estate

MONITOR

Mezzanine Loans: Purchase Considerations

Weakening market conditions means that all forms of real estate interests are being offered for sale. One such is the mezzanine loan, a special form of subordinate financing. Because this type of loan is not secured by a mortgage on the underlying property, the mezzanine lender cannot lay claim to the property in the event of the borrower's default. Instead, the mezzanine lender utilizes forms of security other than a mortgage – normally, a pledge by the fee owner of its equity in the property. For this reason, first mortgage lenders prefer mezzanine loans to second mortgages, and often will agree to them when additional financing is required. The other side of the story is that a mortgage default by the fee owner resulting in a foreclosure will usually mean a total loss to the mezzanine holder unless a guaranty has been obtained from a third party.

The attractions to the lender of a mezzanine loan are several. First, the mezzanine lender receives a higher return than a first (or even a second) mortgagee because of the additional risk that assumed. Second, the mezzanine lender is in a position to acquire title to the property in the event of a default by the owner, assuming the mezzanine lender can cure the mortgage default or enter into an arrangement with the lender. Third, the mezzanine lender, usually fully aware of the financial status of the property, has an edge if the property is put up for sale.

Buyer's Considerations

Given this background, what inquiry should be made by a party interested in buying a mezzanine loan? The first question that should be asked is whether the loan can be sold. A loan that has been securitized may contain a requirement that it can only be sold to certain types of transferees in order to insure that the sale will not cause a credit downgrade of the securities. The next inquiry by the mezzanine loan buyer is whether the inter-creditor

agreement between the first mortgagee and the present mezzanine lender permits amendments to the mortgage loan that increase the risk of default. For example, the inter-creditor agreement should restrict the lender from increasing the loan amount or interest rate, changing the maturity date or adding provisions that cross-default the mortgage loan with other debt.

Cure Rights and Purchase Rights

The buyer of a mezzanine loan will want to insure that the senior lender will give the mezzanine lender notice of, and adequate opportunity to cure, defaults of the mortgage loan.

An inter-creditor agreement often will give the mezzanine lender the right to purchase the loan in the event of a default rather than curing the default. The buyer of the mezzanine loan should be sure to review the terms of such cure rights (or negotiate for such rights if they are not already provided). In particular, a buyer should be clear as to the time period that is allotted to exercise the purchase right and whether any prepayment of other penalties must be made.

Finally, the prospective buyer should confirm that in the event of a default of the mezzanine loan, cash flows remaining after payment of operating costs and the mortgage will not be disbursed to the property owner. Unlike the mortgage lender, the mezzanine lender has no lien on the property and so is not able to have a receiver appointed to collect rents and administer the property in the event of defaults, thereby protecting their position.

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Real Estate

MONITOR

Leases: Reviewing Annual Operating Expense Statements

As the new year begins, commercial tenants can anticipate receiving an envelope from the landlord containing the Operating Expense Reconciliation Statement. Typically prepared in the first or second quarter of the year for the prior calendar year, the statement reflects the tenant's obligation – spelled out in more or less detail in the office lease – to pay a share of increases in the total occupancy costs of the building, often the second highest expense after payroll.

Tenants today accept the idea that increasing costs constantly chip away at the landlord's profit margin which was carefully calculated into the basic rent set when the lease was executed. In order to preserve the profit margin, landlords expect the building tenants to absorb increased costs of operating the building due to higher property taxes and a higher level of services. Notwithstanding their awareness of the escalation clause in their leases, tenants often are taken by surprise when the statement shows expenses much higher than anticipated. The question that invariably comes to mind is whether increases have been properly calculated and whether some costs have been improperly included. At the very minimum, the tenant should take out the lease and compare the cost items in the reconciliation statement with the language of the operating escalation clause.

Allowed and Disallowed Items

Most office leases contain a laundry list of items for which the landlord may charge tenants, along with a list of disallowed items. Some leases describe operating expenses in more general terms. In either case, the annual statement can contain items for which tenants clearly are not obligated to pay as well as items that could be interpreted either as operating expenses or another type of expense – a capital expenditure, for example, or an expense unrelated to the operation of the building. Some costs that should be checked carefully by the tenant include the following.

Salaries: The landlord may include salaries paid to all of its personnel, including cleaning and security staff, managing agent, executives and other staff members. The tenant, on the other hand, will not wish to pay the salaries of the landlord's staff (or the landlord's own salary), since these are not directly attributable to the tenant's occupancy of space. Usually, only the salaries of the managing agent and his subordinates are included in operating expenses; higher-ups are excluded. Further, when an outside management firm is used, its fees should approximate those paid by comparable buildings in the neighborhood.

Expenses for leasing space in the building: The landlord may seek to include expenses such as advertising and promotion incurred to obtain new tenants, as well as brokerage commissions and legal and administrative expenses relating to negotiating new leases or enforcing the terms of existing leases. A tenant may argue that such expenses bear no relationship to the space the particular tenant leases in the building.

Overtime charges: Typically a tenant using its space outside of normal business hours must reimburse the landlord for the overtime costs of HVAC (heating, ventilation, and air conditioning) and sometimes for the costs of a security guard or freight elevator. Such costs always should be excluded from the escalation charges; otherwise the landlord will be twice reimbursed.

Capital expenditures: An operating expense clause in a lease should be very specific in distinguishing repairs and improvements from capital expenditures. Operating expenses customarily include repairs to the common areas of the building as well as to core building systems such as elevators, HVAC, lighting fixtures, wiring, security systems and sprinkler systems. On the other hand, the normal replacement of core systems, or costs incurred to correct structural, design or engineering

Leases: Reviewing Annual Operating Expense Statements

defects should properly be regarded as capital outlays that are the responsibility of the landlord. When an expenditure is for the purpose of modernizing a building system that will reduce operating expenses in the future, the tenant's position should be that such costs can be treated as operating expenses only if the tenant will share in future savings resulting from the improvement. One way to do this is to provide that the annual expense pass-through relating to the improvement will not exceed the amount of the annual cost savings to the tenant.

Outlays required by law: During the lease term, new laws or regulations may require unanticipated capital outlays. For example, a new law may require the installation of equipment to improve air quality, or require the removal of asbestos or the purchase of new safety equipment. The tenant may argue that such capital costs are one of the risks of property ownership and in addition, increase the value of the building. If the tenants are required to pay such costs, the annual pass through should be based on the useful life of the new equipment.

Other charges: Other charges sometimes included in an operating expense reconciliation statement that should be challenged by the tenant (unless clearly authorized by the terms of the lease) include: expenses for which the landlord has been or will be reimbursed by a third party; rent payments under a ground lease; the landlord's routine corporate and administrative overhead; debt service on a mortgage or any loan, fees or penalties; and any loss of value due to any form of depreciation, including normal wear and tear, functional depreciation and social and economic depreciation.

Grossing Up Base Year Expenses

Equally as important as analyzing the expenses included in operating costs are those that may be omitted, especially in your base year. A tenant

expects that it is paying rent for a fully operational and fully serviced building. If the tenant's base year was one of the years when the building was leasing-up, a later year may show an unusual increase in the expense escalation. If expenses in the base year were not adjusted to reflect costs that would have been incurred for a fully occupied building, the tenant may be paying more than he should. Rather than reimbursing the landlord for increases in costs due to inflation, the tenant pays for the added costs associated with having more tenants in occupancy (more area to clean, more trash, etc.) The landlord may even charge a higher management fee for serving more tenants. To avoid this, the escalation clause should provide that expenses in the base year(s) should be "grossed up" to reflect normal occupancy levels.

Self-Protection

Very often a tenant takes great pains to negotiate its operating expense clause, making sure that the list of inclusions and exclusions are specific to its needs and that it contains proper gross-up language. The landlord or its managing agent may not review each tenant's lease before preparing the annual escalation billing. What complicates this further is turnover of owners and managing agents after a sale of a building, or even the natural internal turnover of an owner's accounting staff. Tenants can protect themselves from paying more than their fair share of expenses by retaining auditors whose sole purpose is to review the specific calculation of an operating expense escalation.

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Real Estate

MONITOR

Golf: Too Many Balls

A Georgia appellate court ruled that an express easement allowing golf balls to enter a homeowner's property precluded an action in nuisance and trespass regardless of the volume of balls falling on the property. In 1999, the owner of a large tract of land to be developed into residential lots agreed to subject the lots to an easement in favor of an adjacent property being developed as a golf course. The easement allowed golf balls to fall on the lot and permitted golfers at reasonable times and in a reasonable manner to come on the exterior portion of the lot to retrieve errant golf balls. In addition, the easement provided that under no circumstances will the golf course owner be liable for any damage or injury resulting from errant golf balls. The easement, however, did not relieve golfers of liability for damage caused by golf balls.

The golf course began operations in 2003. At that time, the DeSarnos purchased a lot adjacent to the ninth hole of the course. Mr. DeSarno regarded the presence of the course as an amenity and was aware of the easement. He became a golfer for a period of time. As the years passed, use of the course increased dramatically until about 30,000 rounds of golf were played each year, resulting in 10-15 balls falling into the DeSarnos' yard each day. Over 2-1/2 years, they experienced 23 broken windows, broken outside lights and several near misses with their children, as well as other damage. For safety reasons, the children were not allowed to play in the yard. At that point, the DeSarnos sued the operator of the golf course, seeking damages and a bar on playing the ninth hole. The trial court entered summary judgment in favor of the defendant and the DeSarnos appealed.

The DeSarnos argued that the extremely large number of balls falling on their property constituted an "excessive use" of the easement and therefore amounted to a nuisance.

However, the cases cited by them related not to the number of times an easement is used, but rather to the use of an easement that exceeds its scope or that is intended to benefit a property that is not the dominant estate. None of those circumstances apply here. Said the court, "So long as there is no limit set forth in the easement, a dominant estate may use an express easement an ever-increasing or larger number of times without fear of liability." The court affirmed the summary judgment against the DeSarnos. The case is *DeSarno v. JAM Golf Management LLC*, 2008WL 5076178 (Ga. App.).

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