



## Real Estate

# MONITOR

### Commercial Real Estate: How Will Refinancing Take Place?

Is the consensus correct that commercial real estate (CRE) underwriting became too tight because of the panic-recession, or was it just about right?

Financing all but evaporated, as lenders searched for metrics (underwriting requirements) that limited risks in response to the recession and collapse of CRE values. In recent months, the underwriting environment has improved for properties with quality tenant profiles to levels allowing deals to happen. Loan-to-value (LTV) ratios between 65 and 75 percent are available for various property types and debt-yield requirements have begun to decline. In addition return of CMBS financing has also begun to add liquidity to the market.

#### How will the industry deal with refinancing properties financed at the height of the bubble?

Other than the continuation of "hold and hope," there does not appear to be a plan in place to address the refinancing of properties financed at the height of the market.

Lenders appear to be more active in taking possession of assets but seem willing to hold and operate the assets in order to market and sell as market conditions improve. The financial institutions may have the capital and willingness to continue this non-strategy for the foreseeable future; however, it is unclear what will happen with properties financed with securitized debt as the special servicers are forced to deal with the requirements of the pooling and servicing agreements in addressing these loans. In addition to the above, banks have been telling developers when a loan reaches maturity that current underwriting is now based on more stringent standards. The result has been that when loans are being restructured, each party needs to

clearly understand the motives of the other party.

Appraisers, on their part, are being ultraconservative. Instead of using existing rents as the basis of determining value, they are assuming lower rental rates and so arriving at a lower value for the property. The property owner, on his or her part, may not be willing or able to refinance a maturing loan based on the current value of the property. The concern of the borrower is that there is a likelihood that the property will rise in value in the foreseeable future and they will be unable to access additional financing if forced to refinance based on the current "conservative" appraised value. From the point of view of the bank or other lender, the property owner may need to agree to a shorter loan maturity or such enhancements as additional collateral or guaranties.

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### Proposed New Accounting Rules

The Financial Accounting Standards Board (FASB), in conjunction with the International Accounting Standards Board (IASB), is proposing a new standard for the accounting for leases that could have a major impact on the way tenants choose to lease space.

The new standard, which is to be issued in April 2011 will require companies to book the present value of all future lease payments as a liability on their balance sheets with a corresponding right-of-use asset to comply with "generally accepted accounting principles" or GAAP.

Currently, most tenants reporting under U.S. GAAP detail future lease liabilities on their financial statements rather than on their balance sheets. Currently, many companies list leases as footnotes on their financial statements rather than on their balance sheets. If the change is made, public companies (as well as private companies following U.S. GAAP) will need to record trillions of dollars of existing leases on their balance sheets; the new rules contain no grandfathering clause. This will have significant implications for investors, not all favorable. In many cases the effect will be to weaken the strength of a company in the eyes of investors and could also affect credit ratings. While rating agencies already take into consideration rent obligations, the new standard requires additional disclosures that could shed new light on lease terms. Companies with heavy debt loads, as well as large retailers with thousands of leases, will be most affected. Commercial banks with multiple branches also could be severely hit when the new rules come into effect.

The accounting update could affect the leasing market because it removes many differences in the way companies account for property that they own compared to those they lease. Companies may decide to buy offices, driving down demand for leased space, according to

some experts. Shrinking the term of a lease also may become more common because the longer the lease the higher the debt loads on the balance sheet.

Another complication involves renewal terms. Options to renew that are likely to be exercised must be included in the lease term as if the renewal will definitely occur. This would mean adding more debt to the balance sheet. Another factor to consider are contingent rents (additional rent based on a percentage of sales or other variable). In these cases, the tenant will need to estimate the contingent rent over the entire term of the lease for inclusion on their balance sheets. This would mean adding more debt to the balance sheet and so make renewal options less popular. Another factor to consider are contingent rents (additional rent based on a percentage of sales or other variables). In these cases, the tenant will need to estimate contingent rent over the entire term of the lease for inclusion on the balance sheet. These proposed updates represent a significant change from current for operating leases and are sure to have additional effects on tenant and landlord business strategies.

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## Due Diligence: Purchase With Care

With real estate markets under pressure, buyers are looking for bargains and in some cases may be tempted to quickly close a deal before other buyers appear. As a result a buyer may curtail or even forego customary "due diligence" procedures, even to the extent of putting down a non-refundable deposit before a contract is signed. This could prove to be a costly mistake. Notwithstanding unethical behavior by a seller, a property's physical condition and financial picture may turn out to be much different than expected upon close inspection after the title has passed.

### What is Due Diligence?

Once a buyer has identified a particular property for purchase, the overall due diligence process generally consists of four steps:

- Making a physical inspection of the property and the adjacent area, with particular attention to possible environmental concerns.
- Making a detailed examination of all leases and contracts to confirm rents and terms and to identify any provisions that might affect future cash flow, such as rent concessions, periods of free rent, and below market renewal options.
- Preparing an investment analysis showing of the potential return under different assumptions with respect to interest rates, occupancy levels, rents and expenses.
- In some cases, entering into a letter of intent with the seller as a preliminary to detailed negotiations on the contract of sale.

### Manipulating Cash Flows

Professional consultants such as accountants, attorneys and engineers usually are retained to carry out the steps just described. An experienced investor, however, will want to be sure that particular attention is given to actions of the seller that (intentionally or not) have the effect of manipulating present or future cash flows. The sales price of a commercial property such as an office or apartment building is a multiple of current and future operating income. Any miscalculation as to either the current income or the rate of expected growth could mean the contract price is significantly above the value of the property. Some of the buyer's concerns about present and future cash flows are discussed below.

### Effective Rents

The owner of an office building intending to sell within a short time period can utilize several techniques to increase the rent roll. For example, in the case of a new building still in the lease-up period, the owner might negotiate above-market rentals in exchange for above-market cash and improvement allowances given to the tenants. The allowances in turn can be hidden on the balance sheet. Proper due diligence by a buyer could mean appropriate reductions to the effective rent figures.

### Rollover Lease Assumptions

A critical consideration for a buyer, particularly in a period such as now when market rents are often below contract rent is the schedule of termination dates for existing leases. If a large number of leases are due to expire within the near future and before the market is likely to strengthen, the new owner will face a difficult

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decision as to whether to renew (or seek new tenants) at lower rates or permit the space to remain vacant until rents once again begin to rise. The present owner may have declined an opportunity to extend existing leases at lower rents in order to show a high level of effective rents until the property can be sold. While there is nothing unethical in doing so, a prospective buyer may obtain some negotiating leverage by pointing this out. In addition, a buyer should challenge any renewal assumptions made by the seller about large space leases in the building. A major lease comprising 25 percent or more of a building that will expire within several years of the sale poses a substantial risk to the buyer since the existing tenant or will have negotiating leverage.

### Options and Rights of First Refusal

In the tenant-favorable market of the past few years, tenants often were able to obtain such concessions as options to renew at a fixed percentage discount from "market rates at time of renewal." This can be an invitation to a lawsuit at the time the renewal option is exercised and a buyer must consider how to exercise of such options will affect the income from the property. Similarly, a tenant may have a right of first refusal ("RFR") on adjacent space in the event it becomes vacant during the lease term. Such RFRs can prove to be a serious obstacle to finding a new tenant, particular one seeking a large amount of contiguous space.

### Retail Revenues in an Office Building

Retail space on the main floor of an office building often is an important revenue source. An effective due diligence team will determine whether the existing retail uses are appropriate and provide the maximum

profit opportunity. An owner anticipating the sale of the building may have entered into a lease with a fast food operation or other type of retailer likely to generate high short term profits but that over the long run will detract from the reputation of the building. Alternatively, the owner may have installed a white tablecloth restaurant to serve upscale tenants of the building but which pays below market rent.

### Other Types of Income

Lobby space can be a source of additional revenue for the building by means of kiosks, ATMs, newspaper stands, shoeshine facilities and similar operations. If such income sources already are present, the buyer should question whether they add or detract from the image of the building. On the other hand, if lobby space is unused, consideration should be given to developing such other income sources.

### Property Taxes

Property taxes are a sometimes the largest single expense for an office building. A due diligence team should carefully determine whether the leases require tenants to absorb the cost of property tax increases, including those due to a higher assessment caused by a change in ownership. The present owner may have incurred a large amount of tenant improvement costs shortly prior to the sale that are not yet reflected in an increased assessment.

### Insurance Premiums

The failure to carefully examine the insurance coverage for a building could result in sharply increased insurance premiums for the purchaser. For example, if the present owner has a portfolio of buildings covered by a blanket liability insurance policy, a buyer



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must determine how the premiums have been allocated among the various properties. Since the owner typically can allocate the premiums in any way desired, the premium allocated to the building in question may be much lower than if an individual policy is obtained. In addition, a proper due diligence investigation will determine whether the insurance provider has a satisfactory rating and the loss history of the building.

The foregoing discussion illustrates just some of the many issues to be resolved by appropriate due diligence when purchasing a commercial property.

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### Leases Checking: Property Tax Invoices

Most tenants with escalation clauses in their leases, when receiving an invoice for real estate taxes (usually billed annually or semi-annually), simply pay the bill and assume the correct formula has been applied in determining the tenant's pro rata share. Astute bookkeepers may pull a copy of the lease out of the bottom drawer to verify the formula; once having done so, they are likely to assume that all is well and issue a check.

However, often all is not well for a number of reasons. It is possible that the tenant is overpaying, sometimes by large amounts, its share of the tax bill for the building in which the tenant occupies space. Four mistakes frequently found by audits of property tax bills are:

- Failure of the landlord to share refunds;
- Inclusion of the other property tax bills;
- Failure of tax bills to reflect tax abatements; and
- Incorrect use of higher tax rate.

#### Sharing Tax Refunds

All tax jurisdictions permit owners to file an objection to the valuation of their property by the tax assessor and request a hearing. Owners frequently retain legal counsel and appraisal experts who will seek to demonstrate why the assessment was inaccurate. Often, landlords are very successful in recovering significant amounts through such appeals. In many big cities, including New York City, landlords hire lawyers on an annual contingency basis to protest real estate tax assessments.

A properly drafted tax escalation clause will entitle the tenant to share pro rata in tax refunds received by the landlord, after the landlord has recovered all the costs associated with the appeal. The refund often is to be made in the form of a rent credit rather than an actual reimbursement in cash. Notwithstanding the lease provision, audits

frequently show that refunds are not made unless the tenant discovers that the appeal has been successful. In some cases, property taxes have been reduced over a period of years without any refunds to tenants, notwithstanding the clear requirements of the lease.

**Observation:** A proper lease audit will review public records as a matter of course to determine if any tax appeals have been made and the results of the appeals.

#### Inclusion of the Other Property

Tax assessments are made on the basis of "tax lots." Sometimes, a building may take up only a portion of a larger parcel that has been assessed as a single tax lot, in which case the building tenants will be paying a share of the taxes on the vacant land from which they derive no benefit. In this situation, an initial allocation of the property taxes should be made between the vacant and the improved portions of the tax lot. The taxes allocated to the improvements should then be divided up among the tenants and the landlord in accordance with the lease provisions. Furthermore, if the landlord occupies spaces in the building for its own use, the tenants' share in the aggregate should not include such space unless specified in the lease.

**Observation:** In the case of a shopping center or other project with common areas used by all tenants, typically the tenants are responsible for their share of taxes on the common area. However, the methods of allocation each tenant's share of such taxes differ. For example, under the flat-rate method, the tenant pays a certain number of cents per square foot. Under the more common fractionalization method, each tenant pays a designated fraction of the total. Negotiating a tenant's fractional share involves so many considerations that the unprepared tenant can easily end up paying more than it intended.

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## Leases Checking: Property Tax Invoices

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Determining the proper share requires a study of the lease provision and of the landlord's application of the method set forth.

### Tax Abatements

In many localities, buildings may benefit from tax abatement programs designed to encourage new development or property rehabilitation. These programs create a special problem in connection with tax escalation clauses. The abatements usually phase out over a period of years, gradually increasing the dollar amount of taxes imposed on the building without regard to whether the overall tax rate and assessment has increased. This results in tenants paying a share of higher property taxes even though the increase does not truly represent an increase in operating costs as provided in the lease. Consequently, tenants can be billed incorrectly for property taxes not currently payable because of the abatement program.

An even worse situation can occur when a base tax year is fixed in the lease for a property that has not yet been fully assessed and is also receiving tax abatements. An unwary tenant can see the property taxes double over a short period of time when in reality the fully assessed value of the property has remained constant. The proper solution is to negotiate a tax escalation clause that requires the base year tax to be calculated without the effect of any tax abatement and which reflects the value of the fully completed improvements.

### Incorrect Tax Rate

Property taxes can go down as well as up. In recent years, discoveries of property contamination (i.e., asbestos) has often resulted in lowered assessments and, consequently, lowered taxes. In addition, tax rates are sometimes reduced to attract new business to the locality and increase employment opportunities. Inadvertently,

a landlord may fail to reflect the reduced taxes on the current year's tax invoice to the building tenants. A properly conducted lease audit will reveal such errors.

### Conclusion

The incorrect billing of real estate taxes to tenants can have an enormously compounding effect in the case of a lease audits by qualified professionals can protect tenants against overcharges or enable the tenant to seek recourse when overcharges have been made.

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### Upholding A Letter of Intent

The Oregon court of appeals ruled that provisions in a letter of intent were enforceable, requiring the seller to pay damages for breach of the letter (Logan v. D.W. Sivvers Co., 141 P.3d 589). The case involved the enforceability of a “nonshop” provision contained in a letter of intent to enter into the final purchase and sale agreement for real property. In the nonshop provision, D.W. Sivvers Co. promised Lillian Logan not to solicit other orders or contract to sell the property to a third party for a period of sixty days. The property at issue was a shopping center the plaintiff intended to buy as part of a Section 1031 exchange to avoid tax liability from her sale of a different property. However, 21 days after the letter of intent was executed, Sivvers entered into a sale agreement with a third party. Logan began this action for breach of contract and a jury awarded her the consequential tax losses she suffered, but not the expectation damages she anticipated. The trial court entered judgment notwithstanding the verdict (JNOV) on the grounds the letter of intent was not an enforceable agreement and that even if it were, the claimed damages were unavailable as a matter of law. The appellate court reversed.

Whether a contract exists is a question of law. Sivvers argued there was no enforceable agreement because the parties expressly stated they did not intend to be bound by a purchase and sale agreement. Logan countered by saying the parties did express their intent to be bound by the nonshop provision and provisions to supply and review due diligence documents. This constituted an enforceable agreement to negotiate on those terms and it is that agreement to negotiate that Logan is seeking to enforce. The court said that courts have identified four main types of preliminary agreements.

The first type is one in which the parties have reached complete agreement on all issues

but also contemplate they will set out their agreement in a formal writing. The second type is called “an agreement with open terms.” Here the parties agree to be bound by some terms, but leave others open for the court to fill in. The third type is an agreement to negotiate, which imposes a duty to negotiate on certain terms specified by the parties but if negotiation fails, no final contract will result. The fourth type is the proverbial “agreement to agree” in which the parties do no more than express a desire to complete negotiations.

Here the agreement is of the third type, purporting to bind the parties to certain terms, specifically the “nonshop” provision and the requirement that Sivvers deliver and plaintiff review the due diligence materials. In short it is an “agreement to negotiate.” The traditional view is that parties to such an agreement do no more than express a desire to complete the negotiations and thus such agreements are merely agreements to agree and are not enforceable. There are two primary arguments as to why agreements to negotiate are too indefinite to be enforced. The first is that it is too difficult to determine what the obligation to negotiate consists of – in other words, too difficult to determine what would constitute a breach. The second argument is that it is too difficult to calculate the damages caused by a breach.

With respect to the first argument – that it is too difficult to determine what would constitute a breach – this may be true in some cases. But it should not be a blanket rule barring enforcement of all agreements to negotiate. A better approach is to consider such agreements on a case by case basis to determine whether the agreement manifests an intent by the parties to be bound by the agreement and whether the terms are sufficiently definite to provide a basis for

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## Upholding A Letter Of Intent

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determining whether a breach has occurred.

In this case, the parties expressly manifested their intent to be bound by certain terms governing the negotiation. The key provision provides that “seller agrees to be bound to provide the required due diligence documents within the time required to comply with the non-solicitation provision.” Thus the parties manifested an intent to be bound by certain terms that would govern their negotiations. Said the court, “We see no reason to disregard that expressed intent. Thus the agreement to negotiate is enforceable if its terms are sufficiently definite.” Thus the court concluded that the terms were sufficiently definite.

With respect to the argument that calculating damages is too difficult, courts following the modern trend do not see this as justifying a complete bar to enforcement of agreements to negotiate. If the plaintiff can prove that, but for the defendant’s breach, the parties would have entered into a final contract, then loss of the benefit of the contract is a consequence of the defendant’s bad faith and provided that it is a foreseeable consequence, the defendant is liable for that loss.

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